

## *The Meaning of Life Insurance*

### **Learning Objectives**

*An understanding of the material in this chapter should enable you to*

- 1-1. Identify the needs of individuals and families for which life insurance can provide a solution.
- 1-2. Define the concept of human life value and explain how it relates to life insurance.
- 1-3. Identify and describe the benefits of life insurance.
- 1-4. Explain the use of mortality tables to predict mortality and life expectancy.
- 1-5. Explain the three elements that are the building blocks of a life insurance policy.
- 1-6. Identify and explain the common policy provisions and riders of a life insurance policy.
- 1-7. Describe general federal income and estate tax rules that apply to individual life insurance policies.

### **Chapter Outline**

*Key Terms and Concepts are explained in the Glossary. Answers to the Review Questions and Self-Test Questions are found in the back of the textbook in the Answers to Questions section. 49*

Chapter 1 explores the meaning of life insurance based on the financial needs of individuals and families, and the benefits they may derive from it. It is important for financial advisors to understand these fundamental reasons for having life insurance and the arguments that favor the personal purchase and ownership of life insurance products. This chapter will discuss how life insurance works and analyze the basic ingredients of a life insurance policy: mortality, interest, and expense. It will conclude with a review of the basic

life insurance contract provisions and policy riders, and the income and estate tax treatment of life insurance.

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## **THE MEANING OF LIFE INSURANCE**

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Life insurance, one of the largest and most important industries in America, is a business with far-reaching social and economic implications. Its first concern is economic security. It provides individuals with an important planning tool through which they can obtain financial security for their families and businesses. It also serves the economy as an important channel through which capital is made available to individuals and businesses for economic growth.

Life insurance was once considered an isolated financial product designed to protect policyowners from the financial consequences of premature death. Little attempt was made to integrate life insurance planning with the complete array of products sold by all types of financial institutions. In recent years, it has become increasingly difficult to view insurance products in isolation from a comprehensive financial planning process. This is due in part to the growing popularity of the financial planning approach and in part to the integration of the financial services industry, where a broad range of financial products are being made available within one financial services organization.

Life insurance means many different things to people. It can serve a variety of purposes in one's overall planning for the uncertainties of the future. Life insurance is a risk management tool that can be combined with other products to provide efficient, comprehensive financial plans for individuals and businesses, especially when designing ways to attain financial goals under a variety of uncertain future conditions.

Life insurance creates capital with guaranteed results. It is property bought with a contract and contractual guarantees that will provide large amounts of money upon the insured's death. The amount of death benefit payable is typically considerably greater than the premiums paid into the policy.

If we knew when we were going to die, then life insurance would be far less necessary. The amount of money needed at that date could be saved systematically, through what is called a sinking fund (savings account). However, if the person died before the desired amount was accumulated, there would be no way to ensure that the needed money could be generated. Life insurance is essentially a financial mechanism that guarantees the desired accumulation by the time of death, regardless of when death occurs.

Life insurance is not morbid and it is not for those who die. It provides for those who live, which is why it is called life insurance, not death insurance. It is the only way you can provide a definite sum of money for an

indefinite time in the future. The life insurance contract is the insurer's promise to pay the policy's face amount upon the proof of the death of the insured, backed by one of the oldest, largest, most regulated, and financially sound industries in the world.

### The Themes of This Course

client-focused selling/  
planning approach

This chapter introduces three themes that are central to today's selling/planning process in the financial services industry: the *needs for life insurance*, the *total needs approach*, and the *client-focused selling/planning process*. Financial advisors (see explanation of this term on page xiii of the preface) explore financial needs with their prospects and clients, seeking to implement solutions for those needs. The selling/planning process serves as the organizing framework of this textbook, since it is the foundation of an advisor's professional relationship with his or her clientele.

### Life Insurance Needs

The needs for life insurance are discussed in this chapter. The total needs approach and the client-focused selling/planning approach are discussed in detail in chapter 2.

### Total Needs Approach

The *total needs or comprehensive approach* is a professional approach to insurance and financial planning. This method uses fact-finding to determine the client's overall financial and personal situation, goals, and needs in order to intelligently assist the client in achieving his or her objectives. As a financial advisor, your role is twofold. First, you help your clients and prospects identify and understand the financial problems and needs their death will create. Second, you encourage and help them to solve those problems and to implement solutions for their survivors.

The *total needs approach* is the foundation of the client-focused selling/planning process discussed in chapter 2. In order to solve a prospect's problems and help a prospect achieve his or her financial objectives, the advisor must conduct a total needs analysis. Just as a medical doctor who makes a diagnosis and prescribes a treatment without obtaining a medical history would be guilty of malpractice, so too would the financial adviser be guilty of unprofessional behavior by recommending a plan without conducting a fact finding and suitability analysis based on the client's total personal and financial situation.

**Client-Focused Selling/Planning Approach**

This book emphasizes the role of the advisor as a professional counselor. It explains the importance of building client relationships and offering value to the customer in the selling/planning process. A client/advisor relationship based on trust is at the heart of this approach. The objective for the advisor in a client-focused selling/planning approach is to develop long-term, mutually beneficial relationships with clients. The advantage of this approach is developing a clientele who view the advisor as a trusted financial professional. In the long term, it is a better way to do business—one that should lead to new sales and referrals, increased persistency, and additional cross-selling opportunities. The benefit to the client is finding a reliable, trustworthy professional advisor who has his or her best interest in mind and on whom they can depend for help in achieving financial goals.

**The Needs for Life Insurance**

A human life possesses many values, most of which are irreplaceable, priceless, and certainly not easy to measure. These values are based on religious, moral, and social relationships. Many religions believe that human life is immortal and gifted with a value beyond the human mind's understanding. Moral teachings and beliefs, often deeply connected to religious values, maintain that the human life is sacred and must be preserved and held in the highest regard. A person's relationship with other human beings creates a set of emotional and sentimental attachments that cannot be measured in monetary terms or replaced by material things.

These values, however important as they may be, are not the foundation of life insurance. Life insurance does have strong moral and social significance, but life insurance is concerned with the economic values of a human life, derived from its earning capacity and the financial dependence of others on that earning capacity. However, the earning capacity of a human life by itself does not create an economic value and serve as the basis of life insurance. A human life has an economic value only if some person(s) or organization depends upon or expects to receive some monetary benefit through that life. If an individual is without dependents and no other person or organization stands to benefit through his or her living or stands to lose at his or her death, either now or in the future, that individual's life has no monetary value that needs to be insured.

Life insurance products can satisfy many purposes and needs, and provide numerous economic and psychological benefits to individuals and families. Some of the common *needs for life insurance* include the following:

### **Survivor Income Needs**

The death of a working family member usually terminates an income stream that the family or other survivors have relied on. The spouse and children need to be provided for during the dependency (child-rearing) period and beyond. There will be continuing costs for food, transportation, and utilities. The surviving family members will want to continue their established lifestyle and they will typically generate the same level of expense they encountered before the insured's death. This means a continuation of bills for cable TV services, magazine subscriptions, cellular phone service, newspapers, club memberships, entertainment, and other miscellaneous costs. Changes in a family's standard of living are usually accomplished through a certain amount of trial-and-error adjustment over a period that often exceeds one year.

This death can leave a surviving family adrift with unfulfilled dreams and expectations, as well as outstanding financial obligations, if care has not been taken to meet the needs of those left behind.

income needs

It is common to classify the survivor's *income needs* into three categories:

readjustment period

**Readjustment Income.** The *readjustment period* is the interval of time immediately following the insured's death, during which income is usually provided at or near the level enjoyed by the family during the insured's lifetime. In the dependency period thereafter, the income drops to a more realistic and sustainable level.

Few individuals are able to leave an estate, including life insurance, substantial enough to provide their dependents with an income as large as they enjoyed while the income earner was alive. This means that an adjustment will generally have to be made in the family's standard of living. To cushion the economic and emotional shock, however, it is desirable to postpone that adjustment for a period following the income producer's death. The length of the period depends largely on the magnitude of the change that the family will have to make in living standards. If the surviving spouse must refresh or acquire skills to gain employment, a longer period may be needed. Whatever the duration, the income during this readjustment period should be approximately equivalent to the family's share of the producer's earnings at the time of his or her death.

The emotional turmoil following the death of a close family member typically lasts about one year or more. As survivors cope with the emotions of anger, denial, depression, bargaining, and finally acceptance of the death, the grieving process often distracts them from concentrating on financial issues. They may forget to pay important bills, such as premiums on homeowner's and auto insurance that could worsen their financial position. Creditors insisting to be paid immediately can be an additional source of

emotional stress at this time. Survivors who are able to show these creditors that adequate life insurance will be available are usually not pressed for collection until proceeds have been received.

**dependency period**

**Dependency Period Income.** The *dependency period* is the interval between the end of the readjustment period and the youngest child's self-sufficiency, usually assumed to occur at age 18, unless the child is mentally or physically disabled. Minor children and other dependents may need to be supported for a lifetime or at least until they become self-supporting. A surviving spouse may need to be supported during this dependency period as well, rather than being forced to enter the labor market. Life insurance proceeds can supplement other income sources that the survivors may receive. The other sources of support available to the children, like all other needs of the family, will affect the children's financial needs.

Most people assume major responsibility for the support and maintenance of their dependent children during their lifetime and consider it one of the rewarding experiences of life. In any case, the law attaches a legal obligation to the support of a spouse and children. If there is a divorce or a legal separation, the court will normally decree support payments for dependent children and possibly alimony for the dependent spouse. In some cases such payments, including alimony, are to continue beyond the provider's death, if the children are still dependent or if the alimony recipient has not remarried. In such an event, the parent and/or ex-spouse is required to provide life insurance or set funds aside in trust.

Another group of family dependents that may have a period of dependency are the husband and wife's parents. The financial demands of providing parental support can be minimal—providing room and board in the home, for example. At the other end of the spectrum, support of a parent in an institution can be very expensive.

Payments to enhance someone's lifestyle, however, are not necessarily restricted to children or other family members. Payments are sometimes extended to lifelong domestic partners, helpers, and caregivers as an informal pension, perhaps for the recipient's remaining lifetime. Life insurance can fund these payments if the benefactor dies first.

**Life Income for Surviving Spouse.** In life insurance planning (discussed in chapter 5) it is necessary to divide the widow(er)'s basic need for life income into two periods. One period runs from the youngest child's 18th birthday to the widow(er)'s 62nd, and the other starts when the widow(er) is age 62. This breakdown is necessary because the surviving spouse's income from Social Security terminates for the child at age 16, with some exceptions (explained in chapter 5) and does not resume until the surviving spouse is aged 62. A permanently reduced benefit is available at age 60. The period in between is usually called the *blackout period*.

**blackout period**

The surviving spouse may require income beyond his or her eligibility for Social Security benefits and private pension plans. Supplemental income may be needed to support the surviving spouse indefinitely.

#### The Moral Obligation to Provide Protection

From the family standpoint, life insurance is a necessary business proposition that may be expected of every person with dependents as a matter of course, just like any other necessary business transaction which ordinary decency requires him to meet. The care of his family is man's first and most important business. The family should be established and run on a sound business basis. It should be protected against needless bankruptcy. The death or disability of the head of this business should not involve its impairment or dissolution any more than the death of the head of a bank, railroad, or store. Every corporation and firm represents capitalized earning capacity and goodwill. Why then, when men and women are about to organize the business called a family, should there not be a capitalization in the form of a life insurance policy of the only real value and goodwill behind that business? Why is it not fully as reasonable to have a life insurance policy accompany a marriage certificate, as it is to have a marine insurance certificate invariably attached to a foreign bill of exchange? The voyage in the first instance is, on the average, much longer, subject to much greater risk, and in case of wreck, the loss is of infinitely greater consequence.

*Life Insurance*, Dr. Solomon S. Huebner

#### *Survivor Cash Needs*

##### cash needs

The above-outlined needs are income needs in which an amount of money is needed over a period of time to sustain survivors; those below are identified as cash needs. *Cash needs* are typically a one-time or otherwise lump-sum need for money which can be planned for and set aside in the case of death, or provided through life insurance.

##### final expenses

**Final Expenses.** *Final expenses* are those costs related to dying. Funeral expenses are not the only expenses associated with death. Some people will incur large medical bills in a last illness that are not covered by insurance. Home or convalescent care is rarely covered by private insurance and has limited coverage under Medicare for those over 65. Prolonged medical, rehabilitative, and custodial care will often leave the family's finances devastated even before death occurs.

Many of the expenses associated with death are incurred after the funeral. There are costs of settling financial and property matters in closing the deceased's estate. Included are court fees, administrative costs, attorney's fees, probate expenses, possible investment and real estate management fees, and potential estate and inheritance taxes.

Managing the estate prior to final property disposition may be extremely complex, requiring the services of specialized investment and/or real estate managers to safeguard the property until it can be sold or distributed. The provisions of the will and the nature of the property involved may necessitate a long period of estate management before the estate can be closed. Some assets may be hard to sell in the economic conditions following death. The terms of the will may require the establishment of trusts and other legal work that is also very time consuming. Even the task of locating heirs or other beneficiaries of the estate may require a lengthy search to obtain death certificates for all potential recipients who predeceased the insured. The longer this process takes and the more complex it is, the more it will cost.

**emergency fund**

**Emergency Fund.** There is a general rule in financial planning that a person or family should set aside enough cash to cover about 3 to 6 months' expenses for emergency needs. This is of increased importance in the case of death of an income producer. Possible damage to or repairs needed for cars, home maintenance, health costs, and other expenses that may occur unexpectedly should be anticipated.

The family should have an adequate source of *emergency funds* in liquid holdings to meet any need for immediate cash prior to or following the death of an income producer, as well as at any other time. Liquid holdings might include money market funds, mutual funds, bank balances, cash management accounts, and life insurance cash values.

**Mortgage Cancellation.** For many families, it is important to know that in the case of the death of a parent or wage earner, the family would have a place to live debt-free. In the case of renters, a rent fund can be established that would accomplish essentially the same goal. If the family can occupy the home free of a monthly mortgage or rent payment, it will greatly reduce the amount of income that they would otherwise require.

**Debt Liquidation.** Some personal debts become due and payable upon the death of the borrower. This may include loans for automobiles, education, business, credit cards and other retail balances, and the like. Many families desire to have a debt-free situation when the wage earner dies. Debt can create an economic hardship for the survivors who do not have the funds to repay it. Standard types of life insurance policies may be lower in cost than credit life policies. Adequate amounts of life insurance will give the survivor the option of paying off the debt in full or repaying it according to a schedule.

**Education Funding.** Although educational goals vary widely from one family to another, children commonly need financial support to reach their educational objectives. The cost of college, professional, and other post-

secondary education continues to climb annually. Life insurance can guarantee that the necessary money will be there in case a parent dies.

A family's educational needs are not restricted to the children. A surviving spouse may need further education to increase future income potential to help support the family. The spouse may need a modest refresher course or training to return to a prior occupation. On the other hand, the spouse's need may be extensive, such as preparing to enter the job market for the first time or trying to upgrade to a higher-paying career. There is even the possibility that a surviving spouse may need training for a less demanding career if he or she has become permanently disabled in some manner.

***Supplemental Retirement Funding.*** Life insurance proceeds can be an important source of funds for a surviving spouse, supplementing other sources of retirement income from corporate pensions, IRAs, other qualified plans, savings and investments, and Social Security.

***Charitable Donations.*** Life insurance can increase the value of a gift to charity. A charity can be gifted a policy, named as beneficiary, or be the owner and premium payer on a donor's life.

Life insurance can also be used for charitable giving even if the charity is not a beneficiary of the insurance policy. The donor can use adequate amounts of life insurance to fund all of the needs of surviving family members and thereby free up personal property and other assets for lifetime gifts to charities.

Gift tax and estate tax considerations are often strong motives for making charitable gifts. Because tax laws are complex and change regularly, tax planning should be carefully coordinated by a knowledgeable tax advisor.

***Gifts to Individuals.*** The beneficiary of a life insurance policy can be a trust for the benefit of heirs or other recipients for whom the insured cares. One advantage of life insurance gifts is that they are generally free of probate and therefore not a matter of public record or subject to probate expenses. The grantor (donor) of the gift can increase the value of the gift using life insurance when transferring property to younger generations. Very sophisticated arrangements can be created to maximize gifts and transfer assets, often with income, gift, and estate tax advantages.

***Supplemental Cash for Future Needs.*** Life insurance can provide supplemental funds for many financial needs by using the cash value of life insurance via policy loans or cash withdrawals prior to an insured's death, without terminating the policy itself. The interest rate for policy loans is known in advance and is usually lower than the rate available on loans from other sources. The primary role of life insurance is protection; cash

accumulation should normally be viewed as a secondary purpose. Any loans or withdrawals made from a policy will reduce the death benefit protection.

Because life insurance provides a safety net and guarantees a certain sum at death, true saving is possible. Saving requires time, and life insurance provides a hedge against the possibility of a savings period being cut short. This refers to the self-completing characteristic of life insurance; it provides the money that an otherwise healthy and capable income-earner cannot because of premature death.

#### ***Tax-Advantaged Vehicle for Saving***

Under current tax law, cash value life insurance policies have several tax advantages for accumulating money. Cash value insurance is said to provide “double-duty” dollars, because money can be made available for the future whether the insured dies or not. The internal buildup of cash value is tax deferred. Money can be taken from the policy in the form of loans or withdrawals that are normally not taxable. The policy can provide tax-free income if the policy stays in force until the death of the insured. If the policy pays dividends, they can be withdrawn tax-free until the cost basis (the amount paid in) is recovered from the policy.

### **The Economic Bases of Life Insurance**

#### ***Human Life Value***

The human life value concept was developed to measure the economic value of life. The most comprehensive approach was provided by Solomon Huebner, the founder of The American College. In his book *The Economics of Life Insurance*, Huebner defined *human life value* as the production potential of the individual over his or her life expectancy. Human life value is a measure of an individual’s net future earnings—that is, the expected future earnings or service of an individual after subtracting self-maintenance costs. From the standpoint of dependents, an individual’s human life value is the measure of the value of benefits that the dependents can rightfully expect from their breadwinner or supporter (from *Life Insurance* by Huebner and Black).

human life value

**The Many Uses of Life Insurance, The Swiss Army Knife  
of Financial Products**

You can use life insurance to:

- Provide a death benefit
- Provide income to survivors
- Secure a line of credit
- Fund a buy-sell agreement
- Guarantee future insurability
- Equalize an inheritance
- Pay estate taxes
- Create an estate
- Give to charity
- Supplement college, retirement, and other expenses
- Pay funeral and last expenses
- Pay mortgages and debts
- Provide an employee benefit
- Protect a business from financial loss

The basic economic premise for life insurance planning is that nearly everyone has a human life value that should be assessed and protected in the same manner as any other valuable asset would be. Those who are capable of earning or providing service in excess of self-maintenance costs have an actual calculable monetary value to their dependents. Human life value for insurance planning purposes is the present value (today's value) of a future stream of net economic contributions a person will make to his or her family.

In many cases, an income producer's family is completely dependent on his or her personal earnings for subsistence and the amenities of life. The "potential" estate (future earnings) is far more substantial than the existing estate (the savings that the family has been able to accumulate). The family's economic security lies in the earning capacity of each income earner.

Over a period of time, these economic forces are gradually converted into income, a portion of which is devoted to self-maintenance, a portion to support of dependents, and, if the income is large enough, a portion to savings to meet future needs and contingencies. If the individual stays in good health, the total income potential will eventually be realized, all to the benefit of the family and others who derive financial gain from his or her efforts. If an income earner dies or becomes permanently and/or totally disabled, the unrealized portion of his or her total earnings potential will be lost, and in the absence of other measures, the family will soon find itself destitute or reduced to a lower standard of living than it previously enjoyed.

This need not happen, however, since there are life insurance contracts that can create a fund that will partially or even fully offset the insured's lost income. By means of life insurance, an individual can ensure that the family will receive the monetary value of those income-producing qualities that lie within his or her physical being, regardless of when death occurs. By

*capitalizing this life value* (creating a fund large enough to generate ongoing investment income similar to the salary or wages of the individual), an income earner can leave the family in the same economic position that they would have enjoyed had he or she lived.

Human life value is measured daily in wrongful death lawsuits. The economic loss to the family and other survivors is the basis for determining monetary awards in these cases. When a wrongful death suit is filed, both sides routinely retain economists to evaluate the victim's human life value. This was the method used in determining awards to families of victims of the 9/11 attacks. A family can be awarded large sums of money for their economic loss of income, services that would have been provided by the deceased, and loss of employee fringe benefits and household services. These judgments are based on the human life value concept. When a car is destroyed, it can be replaced through auto insurance. With life insurance, when the insured dies, he or she cannot be replaced; only the financial contribution he or she makes to the family is replaceable.

Calculating this value is not an exact science because much of the calculation's accuracy depends on what actually happens in the future. There are also many noneconomic contributions of a family member, which are more difficult to measure. Regardless of precision, the purpose of life insurance is to replace someone's human life value in the event of death.

How much is the appropriate amount upon which to base a life insurance recommendation? The human life value approach will play a significant role in defining the economic need for life insurance. Calculating life insurance amounts and planning techniques for this purpose will be covered in chapter 5.

#### ***The Money Machine Analogy***

An example of the application of the human life value concept in selling life insurance is the money machine analogy, which compares a person's income-producing capability to that of a machine. The money machine analogy asks the prospect to imagine that he or she had a machine that could print money as it was needed. If possible, would he or she insure the machine to guarantee that if something happened to it, the money could continue to support the family and maintain their lifestyle? Most people would say yes. The advisor then points out to the prospect that the income he or she produces makes him or her very much like a money machine. What would happen to the family if the prospect died or became disabled and was no longer able to produce income? Wouldn't it make sense for the prospect to insure his or her life and earning capacity?

### ***Time Value of Money***

**future value** If a 35-year-old man earned \$30,000 net of taxes and expenses, and worked for 30 more years to age 65 without ever getting a raise, the economic value to his family would be \$900,000 (30 years x \$30,000). Of course, it doesn't take \$900,000 to produce \$30,000 over 30 years; a sum of money would be earning interest through the 30-year period. Money has a *time value*, which is based on the capacity to earn interest. Interest is the difference between the money's value today (*present value*) and the value of the money in the future (*future value*). To the investor, interest is the money earned on invested capital; to the borrower, it is the money paid for the borrowed capital.

**present value** The sum that will be needed to produce income over the next 30 years can be discounted to a present value. *Present value* expresses the value of money today that is to be received in the future. A simple way to calculate this amount is to divide the desired income by the assumed after-tax interest rate. This will determine a lump sum that will produce the required income at the assumed rate indefinitely. For example, \$30,000 divided by 5 percent will produce a required capital amount of \$600,000. We will discuss this process in chapter 5.

Another way to illustrate the value of insuring the money machine (human life value) is to compare the relative risk of each type of event we insure to the risk of death. How many homes burn down or cars have accidents? How much do we pay for these types of protection (policies)? What financial loss would we suffer? How many people escape death? What financial loss would our survivors endure?

### **The Benefits of Life Insurance**

When they hear the phrase "life insurance," many people think of the policy that will pay for a funeral. Life insurance is much more than that. It has emotional as well as economic benefits, explained below.

### ***Provision of Time and Money***

Life insurance could also be called "time insurance." When someone dies and the proceeds are paid to the beneficiaries, that money helps buy time until the survivors can adjust, financially and emotionally. Life insurance guarantees large amounts of cash to pay final expenses, repair the car if it breaks down, keep the mortgage payments current, keep the utilities turned on, and generally provide sufficient cash so survivors can maintain the same lifestyle as before the insured's death. Most of the people who come to the survivors to talk about money come with their hands out, requesting payment for goods and services. Only the insurance advisor can walk into a tragic situation and bring new money to pay old and new bills. The insurance

proceeds offer survivors the time they need to adjust and resume their life. This is the advisor's real contribution.

### ***Peace of Mind***

Life insurance may be the only product someone cannot buy when it is needed and desired the most. Let's look at what life insurance offers to the person who buys the policy. First, there is the peace of mind in knowing that a sound and prudent decision has been made. The life insurance contract guarantees payments in the future when cash is needed. This is why we sell life insurance and why people buy it.

#### **What Your Work Means to Your Clients**

When a person can answer either of the following questions with a "yes," who could not say that the work he or she does makes a difference in people's lives?

- Does the product you sell make a difference in people's lives?
- Does the service you perform make a difference in people's lives?

All of you who sell life insurance, especially after careful consideration, should be able to answer yes to both questions. You have a noble calling. Think about the good your work does to society and particularly for those who are privileged to call you "my insurance advisor."

Life insurance policies typically have some protection against creditors of both the policyowner and the beneficiary. This protection varies widely from state to state, but can be of great benefit to those who may depend on the values of the life insurance policy or its proceeds. The principle behind these statutes is that creditors should not be permitted to make someone destitute and a potential ward of the state. Check the statutes in your area to determine which provisions apply.

### ***Living Benefits and Financial Flexibility***

One type of life insurance, *cash value* or *permanent life insurance*, can provide guaranteed funds in case of financial emergency. It can supplement retirement income or provide money for other purposes while the insured is alive. A policy can be used just once, when the insured dies and the death benefit is paid to the beneficiaries, or it can be used often during the insured's life. People who own life insurance turn to the cash value of a policy when all else fails and they face a financial emergency. They know that the funds are there to borrow or withdraw, normally without delay or qualification.

**Ben Feldman**

*And isn't it the same with everyone? We all must die someday. Never at the right time. Always at the wrong time. We never have quite enough time to complete our plan, make our dreams come true—and that's why it's always the wrong time. Who'll give us more time? Only The Man Upstairs. But we can give our clients the equivalent of time in the sense that we can give them the money to complete their plans. You know, we sell contracts for time and money. We Can't guarantee the time—but we can guarantee the money."*

Ben Feldman, *Creative Selling for the 1990's*, Longman Financial Services Publishing, 1989.

No other financial institution can do what life insurance companies can do. No other industry backs its products with reserves as sound as those of the life insurance industry. In fact, during the Great Depression of the 1930s, when the stock market hit bottom and many banks went out of business, insurance companies provided security for their policyowners that was unavailable anywhere else. While well-established companies in other industries went bankrupt, fortunes were lost overnight, and income from real estate and other property evaporated, the failure of life insurance companies was unknown. In no case was there any loss to a continuing policyowner.

***A Financial Foundation with Guarantees***

The record of strength and safety of insurance companies even under the most adverse conditions is a badge of pride to the insurance industry. For generations, life insurance has been the standard of security by which others are measured. Guarantee Associations that protect policyowners and beneficiaries if an insurance company becomes financially insecure have been established in various states to provide further safety. No investment or other type of business has had a safety record superior to that of life insurance.

Part of the reason for this safety is the way insurance companies manage and invest their assets. They look for real estate, mortgages, corporate and government bonds, and other investments that will bring consistent returns without compromising safety. Insurance companies invest for the long term because people buy insurance for the long term. These investments are designed to provide a consistent and stable return that gives the insurance company a dependable income to pay its obligations and honor the guarantees that make up the life insurance contract.

**I AM A LIFE INSURANCE POLICY**

I am a piece of paper, a drop of ink, and a few pennies of premium.  
I am a promise to pay.  
I help people see visions, dream dreams, and achieve economic immortality.  
I am education for the children.  
I am savings.  
I am property that increases in value from year to year.  
I lend money when you need it most, with no questions asked.  
I pay off mortgages so that the family can remain together in their own homes.  
I allow people to dare to live and to die responsibly.  
I create money where none existed before.  
I am the great emancipator from want.  
I guarantee the continuity of a business.  
I conserve the employer's investment.  
I am tangible evidence that a man is a good husband and father, and that a woman is a good wife and mother.  
I am a declaration of financial independence and economic freedom.  
I am the difference between an old man or woman and an elderly gentlemen or lady.  
I provide cash if illness, injury, old age, or death cuts off the breadwinner's income.  
I am the only thing that can be bought on the installment plan that a family doesn't have to finish paying for.  
I am protected by laws that prevent creditors from assessing the money I give to loved ones.  
I bring dignity, peace of mind, and security to the family.  
I supply investment capital that makes the wheels turn and the motors hum.  
I guarantee the financial ability to have happy holidays and the laughter of children—even though father or mother is not there.  
I am the guardian angel of the home.  
*I am life insurance.*

***Income and Estate Tax Advantages***

The following points are general rules, and are subject to limitations and exceptions. More discussion of the tax treatment of life insurance appears at the end of this chapter.

Life insurance generally offers a number of tax advantages:

- There is normally no income tax payable on death proceeds.
- Cash value policies generally allow for *tax-deferred* internal buildup of cash value as long as the policy remains in force.
- An individual can retrieve his or her investment in the policy before recognizing gains.
- Dividends paid to the policyowner are generally not subject to federal income taxation until the total dividends paid exceed the total premiums paid into the policy.

- Policy loans are normally not considered income. If done correctly, a combination of withdrawals and policy loans can produce tax-free income from a permanent life insurance policy while the insured is living.
- There is no estate taxation on the death proceeds if the insured had no incidents of ownership in the policy and the beneficiary is not the insured's estate, executor, or administrator, or there is no obligation to pay estate expenses with life insurance proceeds.

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## **BASIC INSURANCE PRINCIPLES**

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### **How the Product Is Created**

All life insurance products are actuarially created by calculating the relationships of mortality, interest, expense, and the financial values attached to each based on time. These factors determine the premium at which a policy is sold. The premium must be adequate to pay the expenses incurred in creating, offering, and maintaining the product, paying all promised benefits, and increasing the insurer's profit and surplus.

These duties belong to the company's actuarial department. The primary responsibility of the actuarial department is to ensure that the company's insurance operations are conducted on a sound financial basis. This includes determining appropriate premium rates and establishing adequate policy reserves. The department generally handles the insurer's mathematical operations, develops new policies, analyzes earnings, provides statistical data from which the annual dividend scale is established, and conducts mortality, lapse, and other studies.

From an economic viewpoint, insurance is a system for reducing financial risk through the transfer of those risks from policyowners, and pooling those losses by the insurer. Insurance achieves the sharing of risk by transferring risks from individuals and businesses to financial institutions specializing in risk.

From the viewpoint of society, insurance is a device for accumulating funds to meet uncertain losses of economic value, carried out through the transfer of the risks of many individuals to one person or group of persons. The social aspect of insurance involves the collective bearing of losses through contributions by all members of a group to pay for losses suffered by some group members. Insurance substitutes certainty for uncertainty through the pooling of hazards to which groups of people are exposed. Uncertain risks of individuals are combined, making the possible loss more certain, and providing a financial solution to the problems created by the loss. Small, periodic contributions by the individuals provide a fund from which those

who suffer loss may be reimbursed. Insurance thus manages the uncertainty of one party through the transfer of particular risks to another party (the insurer) who offers a restoration, at least in part, of economic losses suffered by the insured individual.

Finally, from a legal standpoint, an insurance contract or policy transfers a risk (for a premium) from one party, known as the policyowner, to another party known as the insurer. By virtue of a legally binding contract, the possibility of an unknown large financial loss is exchanged for a comparatively small certain payment. This contract is not a guarantee against a loss occurring, but a method of ensuring that payment will be received for a loss that does occur.

Every insurance company will add cost and pricing variables to the actual historical results of that company in designing and pricing its products. This is the same procedure as any product on the market, not just insurance. It also accounts for the variations in premiums between products that might appear to be the same. Variations can be created by differences in company operational efficiencies, investment performance and assumptions, underwriting practices, profit and marketing objectives, sales results, service practices, policy persistency, expenses, and other issues.

### ***Statistical Predictability***

Mortality is statistically predictable. Everyone will die eventually. Time becomes a critical factor when we recognize that we never know when someone will die, only that everyone will. Combine the reality of death with the uncertainty of when it will occur, and you have the basis for life insurance. It is the scientifically calculated pooling, growth, and distribution of money to satisfy two objectives for paying benefits:

- paying benefits to survivors of someone who dies
- providing distribution of benefits with guaranteed lifetime payments to either the insured or the insured's survivors

Only life insurance and annuities can do these things. To accomplish this, insurance companies keep extremely accurate records about births and deaths, especially when (by age) and how (by cause) people die. The size of the statistical base, now hundreds of years old, enables insurance actuaries to predict average mortality for groups of people in many different categories. This precision study of mortality and how it works helps to make life insurance a risk management tool rather than a game of chance. It is an actuarial science—mathematical calculations of probability based on huge amounts of experience—that establishes mortality tables, life expectancies, and reserve requirements that are used to create and price life insurance products.

law of large numbers

**The Law of Large Numbers**

The statistical group that is observed for purposes of measuring probability must have mass—that is, the sample must be large enough to allow the true underlying probability to emerge. The *law of large numbers* states that as the size of the sample (insured population) increases, the actual loss experience will more and more closely approximate the true underlying probability. This means that the insurer's statistical group must be large enough to produce reliable results, and that the group actually insured must be large enough to produce results that are consistent with the underlying probability.

**Risk Pooling**

Life insurance uses what is called risk pooling or group sharing of losses. People exposed to a risk agree to share losses on an equitable basis. They transfer the economic risk of loss to an organization (the insurance company). Insurance is based on pooling the premiums of thousands of people and spreading the risk of losses across the entire pool. By carefully calculating the probability of losses that will be sustained by the members of the pool, insurance companies can equitably (fairly) spread the cost of the losses to all the members. The risk of loss is transferred from one to many and shared by all insureds in the pool. Each person pays a premium that is measured to be fair to them and to all based on the risk they impose on the company and the pool (each class of policies should pay its own costs).

**Risk Pooling Examples****Homeowner's Insurance**

Of 1,000 houses, each worth \$200,000, assume only one house per year is destroyed by fire. Each homeowner could contribute \$200 per year into a pooled fund that could pay out the full \$200,000 value to the homeowner of a destroyed home. Such pooling transfers the risk of bearing the full impact of a potential \$200,000 loss by an owner.

**Life Insurance**

Ten thousand males aged 35 contribute to a life insurance pool. Twenty-one of them are expected to die this year (based on 1980 CSO mortality tables). The mortality charge is \$2.10 per \$1,000 of benefit. If each of the 10,000 contributes \$210 to fund death benefits (ignoring costs of operation), a death benefit of \$100,000 could be paid for each of the 21 expected deaths.

## The Building Blocks of the Life Insurance Policy

### *Mortality, Interest, and Expense*

mortality, interest,  
expense

Every life insurance product, regardless of type, must take into account these three factors: *mortality*, *interest*, and *expense*, in the construction and operation of a life insurance product. The assumptions made concerning these three factors will determine the policy premium and the structure of the policy. The actual results over time, called experience, will determine the profitability and solvency of the life insurance company.

### *Understanding Mortality Tables*

National Association  
of Insurance  
Commissioners  
(NAIC)

2001 Commissioners  
Standard Ordinary  
(CSO) Mortality  
Tables

Every 20 years or so, new mortality tables are developed for individual life insurance products by the *National Association of Insurance Commissioners (NAIC)*. Because insurance is regulated by individual states, the NAIC is an association of the state insurance commissioners which creates model regulations that can be adopted by the states to create product uniformity. In December 2002, the NAIC adopted the *2001 Commissioners Standard Ordinary (CSO) Mortality Tables*, replacing the insurance reserve valuations based on the previous 1980 CSO Mortality Tables. As a result of improving mortality over the previous 20 years, these tables reflect lower mortality rates and will affect many of the products you sell.

Generally, the reduction for males is more significant than for females, and for nonsmokers than for smokers. One significant change is the extension of life mortality to attained age 120 (compared with age 100 with the 1980 CSO). These changes will lower the statutory reserves, the money required to back up life insurance contracts by state insurance departments.

These changes are taking effect over the next few years as state insurance departments approve the 2001 rates for policy reserve valuation. These changes will affect newly issued policies only. The vast majority of in-force policies are and will continue to be regulated under 1980 CSO requirements. Once fully adopted, the new tables will take full effect for federal tax reserve valuation, necessary for the product to meet the tax definition of life insurance, with full implementation to be mandated by 2009 at the latest.

The 2001 CSO tables include several mortality tables that vary by gender, smoking status, ultimate and select rates, and age-last-birthday and age-nearest-birthday bases. Select rates are for those insureds who have recently provided evidence of good health and have been underwritten. Ultimate rates are higher and used for renewal purposes, to account for the longer period since evidence of insurability was provided and the deteriorating pool of those insured.

Review the following mortality charts and refer to them when reading about mortality and its effects on you and your prospects. Keep in mind that

Comment [T1]: Glenn: This sentence isn't finished

larger insurance companies use their own morality statistics in pricing products. These CSO tables are primarily for statutory (regulation by state and federal government) purposes such as reserve requirements and tax issues. These tables may lower the amount the company needs to charge for mortality costs and the amount of premium a policyowner can place in the policy under tax regulations.

Life insurance must meet certain premium and cash value tests to qualify for the tax benefits afforded by the tax code. The new mortality tables should eventually lower the tax reserves required by IRC Sec. 7702 (definition of life insurance) and IRC Sec. 7702A (Modified Endowment Contract) rules, which will consequently lower cash values, nonforfeiture values, maximum cost of insurance rates, and surrender charges for most issue ages and risk classes. This also will lower the amount of premium allowable for a policy to meet the definition of life insurance and modified endowment tests (7-pay rules).

**Using Mortality Tables.** The National Safety Council estimates how many hundreds of persons will be killed on highways between the Friday and Monday of a summer three-day holiday weekend. The actual number will be remarkably close to the estimate. Of course, when it makes its estimate, the Council has absolutely no idea who will be killed. It merely applies the laws of large numbers and probability to make its estimate. Because the Council has a great volume of historical information available, and because large numbers of people are involved, these predictions are generally quite accurate. For life insurers, the process is similar.

Life insurance companies pool their information to construct mortality tables that will accurately indicate the number of insured persons in any large group who will die at any particular age. The 2001 CSO tables indicate that about one of every thousand male babies born in the United States can be expected to die before their first birthday. After age 1, the death rate declines until age 4, and then begins to increase at age 6 and every year thereafter. Mortality in males averages less than one death per thousand each year until age 20 (using composite rates). Generally, people are more likely to die each year that they live beyond early childhood.

**Life Expectancy.** Both 2001 and 1980 CSO table rates are included for illustrative purposes, since 1980 CSO mortality represents the vast majority of in-force life insurance. According to the 1980 mortality tables newborn males have a life expectancy of 70.83 years and newborn females 75.83 years. If a male child survives to age 10, his life expectancy increases to age 71.66. If he is still living at age 60, his life expectancy is age 77.51. At age 80, he has a life expectancy of 6.18 additional years, or age 86.18. At 90, his life expectancy is 3.18 years or age 93.18. In the past, very few individuals survived past age 100, so the 1980 CSO table assumed that everyone died by

age 100. With longer life expectancies, the 2001 CSO table extends to age 120.

Life expectancy rates for the 2001 tables are greater than the 1980 tables because mortality rates are lower. To compare with the 1980 mortality tables, 2001 CSO life expectancy for a newborn males is 75.67 years and newborn females is 79.87 years. At age 60, a male's life expectancy is age 79.75. At age 80, he has a life expectancy of 6.76 additional years, or age 86.76. At 90, his life expectancy is 3.20 years or age 93.20. Females have similar but higher life expectancies

#### The Rate Is One

"(Prospect), I must admit that when it comes to mortality tables and other actuarial statistics, I am far from expert. I don't know the mechanics of how they work.

"But I do know and understand perfectly what they mean: the death rate is no more and no less than one per person. I am going to die...and you are going to die. We just don't know when.

The odds may be one in a thousand, but when it happens to you, they are one in one and the other 999 don't matter."

**Age and Expectation Differences.** Notice that a person's life expectancy (age at death) is increased by each year the person survives, even though the expectation of the number of years to live decreases. Life expectancy is the combination of age and longevity, and longevity decreases more slowly as age increases. You can see in tables 1-1 and 1-2 that there is no age at which longevity decreases by a full year in any one year. Thus, the older a person is, the older he or she can expect to live, all else being equal.

Life expectancy has significance only for large groups of people. To an individual, life expectancy is a meaningless figure. A 30 year old will probably live to age 70 or 75, but could die today. According to 1980 CSO mortality, if we had a group of 211,000 30-year-old men, all in good health, we could expect one to die every day during the next year (365 days divided by 1.73 x 1,000). Averages, however, are not applicable to individuals for predicting death. They only indicate how many people in a particular age group will probably die. Life expectancy and mortality tables are important to life insurance companies as a basis for determining the values and guarantees that go into policies, but they are not as predictable for individuals.

<b>TABLE 1-1 IRS Life Expectancy Table (Partial) 1980 CSO</b>		
Age Male	Age Female	Life Expectancy (Years)
55	60	21.6
56	61	21.0
57	62	20.3
58	63	19.6
59	64	18.9
60	65	18.2
61	66	17.5
62	67	16.9
63	68	16.2
64	69	15.6
65	70	15.0

<b>TABLE 1-2 Life Expectancy Table (Partial) 2001 CSO</b>			
Age Male	Life Expectancy (Years)	Age Female	Life Expectancy (Years)
55	23.86	55	27.34
56	23.02	56	26.49
57	22.19	57	25.65
58	21.37	58	24.82
59	20.55	59	23.99
60	19.75	60	23.18
61	18.96	61	22.37
62	18.18	62	21.58
63	17.42	63	20.79
64	16.67	64	20.02
65	15.94	65	19.24

<b>TABLE 1-3 2001 CSO Table Male Lives—per 1,000 lives</b>				<b>Female Lives—per 1,000 lives</b>			
Age	Composite	Nonsmoker	Smoker	Age	Composite	Nonsmoker	Smoker
0	0.97			0	0.48		
1	0.56			1	0.35		
2	0.39			2	0.26		
3	0.27			3	0.20		
4	0.21			4	0.19		
5	0.21			5	0.18		
10	0.23			10	0.22		
15	0.61			15	0.35		
20	1.00	0.95	1.27	20	0.47	0.45	0.58
25	1.07	0.98	1.63	25	0.54	0.50	0.77
30	1.14	1.02	1.80	30	0.68	0.64	1.03
35	1.21	1.09	2.00	35	0.97	0.89	1.53
40	1.65	1.46	2.77	40	1.30	1.20	2.12
45	2.65	2.33	4.57	45	1.87	1.71	3.13
50	3.76	3.32	6.45	50	3.08	2.81	5.39
55	6.17	5.50	10.56	55	5.10	4.68	9.08
60	9.86	8.92	16.29	60	8.01	7.40	13.97
65	16.85	15.47	26.63	65	11.85	11.05	20.34
70	25.77	24.10	37.89	70	17.81	16.82	29.82
75	41.91	40.03	57.29	75	27.90	26.64	45.23
80	70.14	67.87	90.07	80	43.86	42.43	66.99
85	116.57	114.07	140.09	85	74.45	72.84	105.41
90	187.66	185.06	214.13	90	121.92	120.65	153.05
95	269.17	267.19	291.05	95	193.66	192.92	214.97
100	363.19	362.10	376.40	100	275.73	275.46	289.27
105	459.21	459.13	460.15	105	410.57	410.56	411.32
110	589.64	589.59	590.27	110	581.77	581.76	582.26
115	765.7	765.67	766.01	115	763.41	763.4	763.66
119	949.22	949.22	949.29	119	935.11	935.11	935.16
120	1000	1000	1000	120	1000	1000	1000

**Chance of Death.** Mortality tables can be important to individuals only as a means of recognizing that young, healthy people will die every day of the year. Consider the 31-year-old prospect who wants to buy life insurance, but waits to make the purchase. Shouldn't this person be made aware that some 31-year-olds will not live long enough to buy the insurance they need if they wait?

Although the chance of dying at age 31 is remote, it does exist. With odds better than 763 to 1 ( $1000 \div 1.13=763$ ), it does not appear that there is a very large chance of dying within the year. Then why should this life be insured when the odds are so heavily in favor of survival for the next 12 months? The answer is simple: Even with such favorable odds, the prospect might still be the 1 in 763 to die. If death would create financial problems, as it usually does, then insure. If death will not create any financial problems whatsoever, then there is no reason to insure. The focus is on solving the problems *when* death occurs, not *if* death occurs. Because knowledge of when death will occur is unknown, the need to insure is critical. It is the sensible response.

### ***Interest***

Insurers invest the premiums that are received and accumulate them for future claims and other obligations. The cash generated by these investments represents a significant portion of the capital needed to operate the company, pay claims, and generate profits. Life insurance company portfolios emphasize safety of principal and predictable rates of return, based on the insurer's long-term obligations. Typically two-thirds or more of this capital is invested in bonds and mortgages, which meet the above criteria. A smaller percentage of common stocks represents under 10 percent of invested capital, due to the volatile nature of stock.

The company will credit interest to policies based on the *new money rate* or on its *portfolio rate*. The new money rate reflects recent investment experience—returns on money that was recently invested. The portfolio rate reflects the insurance company's overall investment return on money invested at various times over the years. During periods of rising interest rates, new money rates benefit; the reverse is true where rates are declining. Because insurance companies expect a block of recently issued policies to have low claims experience as a whole until years later, there is an adjustment to the premium calculation for the time value of money (compound interest). Investment returns are assumed to be at some minimum rate and are factored into the premium calculation.

If the investment results exceed the guaranteed minimum, policyowners benefit either from participating dividends or from excess interest crediting to the policy cash value. The insurance company's operating results may benefit from any investment earnings that are not transferred to policyowners.

***Is Life Insurance an Investment?*** Life insurance is not an investment in the usual sense of the word. In fact, the product was not originally intended

to be an investment in any sense. There is disagreement as to what extent life insurance can be viewed as an investment vehicle.

Life insurance should be the first type of financial product to buy because it pays for the necessities of life at the very time the decedent (deceased) cannot. This makes insurance the foundation of financial security. This is the first of many steps that are needed to provide for the future of the decedent's survivors.

The principal economic purpose of life insurance is to provide capital. Although it should not be viewed primarily as an investment, this is essentially what life insurance is. All conventional investment vehicles serve the same purpose, but the unique feature of life insurance is that it assures a desired accumulation at the specific but uncertain time of the insured's death. No other investment can make such a **guarantee**.

**Comment [T2]:** Glenn: The two middle paragraphs in this section repeat information that was already stated. Suggest that the first and last paragraphs be kept and the middle two deleted.

### **Expense**

***The Cost of Doing Business.*** Just as with any other business, life insurance companies incur costs in the course of doing business. These break down into two principal types: *acquisition expenses* and *administrative expenses*. Acquisition expenses include all the costs incurred in obtaining the business and placing it in force, and can include some or all of the following items:

- advertising and promotion expenses
- commissions and fees paid to advisors and brokers
- underwriting expenses, such as medical exams, attending physicians' statements, inspection reports, and credit histories
- home office processing costs, policy printing, and related fees
- an addition to the insurer's reserve, surplus, and profits
- state premium taxes

Additionally, ongoing administrative expenses incurred by the insurance company must be covered by the premium:

- cost of collecting premiums and distributing dividends
- cost of continuing producer compensation
- investment expenses
- home office overhead

Any cost the insurer incurs must be recovered, either through premium charges or reduced investment credit.

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## REVIEWING THE LIFE INSURANCE CONTRACT

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Few people take the time to read their life insurance policies cover to cover. Even if they did, they would most likely not understand everything they read. They depend on you to explain their policies to them. You need to understand policy provisions and be able to explain them thoroughly and accurately to policyowners. This is immensely important, for the exact language of the policy determines how the provisions will operate. This varies from state to state, company to company, and policy to policy. You can begin by reading the life insurance contract yourself.

The standard provisions of life insurance policies are regulated by the individual states, which control the provisions and policy language that may or may not be used. The policy forms must be submitted to and approved by the insurance department of the state or jurisdiction where it is sold. Current discussion in the legislative and administrative bodies throughout the United States concerns the possible federal chartering and regulation of insurers and insurance activity. This debate has gone on since the founding of this country.

Most life insurance contract provisions are similar to one another because of similar state laws and NAIC model regulation adoption. You would probably have little difficulty finding your way through any company's contracts with some limited experience. To policyowners, however, a multiple-page policy with dozens of largely unfamiliar terms, charts, and tables may seem incomprehensible. You can remove some of the mystery by walking the policyowner through the contract page by page. In most cases, he or she will appreciate your personal interest and concern.

### The Policy Is a Contract

A life insurance policy is a legally enforceable written contract between the policyowner and the life insurance company (the insurer), governed principally by state law. Under such a contract, the policyowner buys the right to a certain sum of money to be paid to a named beneficiary in the event of death, or to the owner if living at the end of a certain number of years. Usually the policyowner is the insured person, but the policy can be owned by someone other than the insured.

The policyowner has the contract as proof of the agreement. It is not the actual policy that is purchased but the right to a sum of money and to the future delivery of it. It is an intangible asset that represents value. It is called a *unilateral contract* because it is the insurance company's guarantee that the money will be paid. A unilateral contract is an agreement in which only one party makes an enforceable promise. The policyholder's only obligation is to keep paying the necessary premiums to keep the policy in force.

**unilateral contract**

**aleatory contract**

The life insurance policy is also an *aleatory contract*, or one in which the values exchanged are not equal. (That is, a small premium is exchanged for a potentially large loss payment, or many premiums are paid with no loss payment). Both parties realize that, depending on chance, one may receive a value out of all proportion to the value that he or she gives. The essence of an aleatory agreement is the element of chance or uncertainty. The agreement is contingent on one party's performance on the happening of an uncertain event.

**contract of adhesion**

A life insurance policy is also a *contract of adhesion*. The contract is drafted by one party and must be accepted or rejected by the other party as it is written. There is no negotiation over the terms of the agreement. The policy is prepared by the company and the policyowner must "adhere" to it. This is important in the case of a legal dispute, because the basic legal rule is that the contract should be interpreted most strongly against the party that drafted it. Anything unclear in the policy is given the interpretation most favorable to the policyowner or the beneficiary.

***Policy Face Page***

Regardless of the trade name that the company uses to market the product, the formal name of the policy is usually printed on the outside cover of the policy form. The outside page also gives the company's name and address and may have a window through which the following information appears.

**policy date**

The insured's full name is usually listed along with the date the insurance officially went into force. The *policy date* is the date that controls premiums and anniversaries, and the *issue date* is the date the company issued the policy, controlling the suicide and incontestability provisions. When a policyowner writes or calls the company about the policy, having the insured's name and policy number on hand will expedite service.

The company's identification number for that policy and the face amount of the policy are typically included, as well as a general description of the type of insurance provided. For example, a traditional participating whole life policy might read as follows:

*Whole Life—Level Face Amount Plan. Insurance payable upon death. Premiums payable for Life. Policy may be eligible for dividends. Dividends, dividend credits, and policy loans may be used to pay premiums.*

This information includes any additional benefits or riders attached to the contract, the premium amount, and the premium frequency for all riders, with the periods of coverage listed in years or by specific dates.

Also usually included are the policy's free-look provision; the insurer's promise to pay, called the insuring clause (the heart of the insurance contract); and the signatures of the officers of the company, usually the president and secretary, which binds the company to the terms of the contract.

The beneficiary's full name may be listed on this same page. Be sure it is spelled correctly. If it is not, check the application to see what name was given. If an error was made on the original application, be sure to submit a change of beneficiary request to the home office or service office with the correct name at once.

### **Policy Provisions**

As a legal contract, the life insurance policy contains standard provisions that regulate its operation. The following are some of the major provisions in the life insurance contract.

#### ***Entire Contract Clause***

The *entire contract* consists of the policy, a copy of the application, and any reports of the insured's physical condition. The policy cannot be changed arbitrarily by the company after it is issued, except in accordance with terms stated in the contract. The company also accepts all statements made in the application as representations (statements made to best of the insured's knowledge and belief). This means that even if they were later proven untrue, the company could not cancel or amend the policy except where fraud was proven. Everything that controls the contract is included in the policy.

#### ***Free-look Clause***

Many states require companies to give policyowners a period of time, usually 10 days, to examine their policies and return them if they are not satisfied. No reason needs to be given. If this is done within the required time period, a full refund of premium will be made—no questions asked.

**incontestable clause**

#### ***Incontestable Clause***

This clause limits the period of time the insurer can use the defense of fraud, concealment, or material misrepresentation to end a contract. Life insurance companies voluntarily introduced this provision to provide greater assurance to the public that relatively innocent misstatements by applicants would not be the cause of a claim being denied. After a policy has been in effect for a period of time prescribed by the incontestable clause (typically 2 years), the insurance company cannot have the policy declared invalid.

Three exceptions to the incontestability provision are generally recognized by the courts:

1. Where no insurable interest existed at the time of application
2. If the policy was purchased with the intent to murder the insured
3. If there had been a fraudulent impersonation of the insured by another person (for example, someone else takes the medical exam)

Under these circumstances the contract was invalid and void from its inception. A typical incontestability provision would read as follows: *Except for accidental death and disability premium payment benefits, we cannot contest this policy after it has been in force for 2 years during the insured's lifetime.*

After the 2-year (in some states, 1-year) period has passed, the policy is incontestable and the full death benefit will be paid if the company has taken no action to rescind the contract.

#### ***Suicide Clause***

To protect insurers from paying death claims on behalf of insureds who might buy life insurance with the intent to commit suicide, contracts contain a suicide clause. This clause reduces the company's liability to a return of the premium if suicide occurs within 2 years of the policy's issue date. With some policies, the term may be limited to one year. The clause is intended to discourage suicide as a reason to buy the policy. A typical clause would read as follows: *For the first 2 full years from the original application date, we will not pay if the insured commits suicide (while sane or insane). We will terminate the policy and give back the premiums paid to us less any loan.*

#### **grace period provision**

#### ***Grace Period Provision***

This clause allows the policyowner 31 days (sometimes 30 days and sometimes 60 days in universal life contracts) to pay premiums after the due date and still keep the insurance in force. If the last day of the *grace period* ends on a non-business day, the period is normally extended to the next business day. If the premium is unpaid at the end of the grace period, the policy normally lapses.

If the insured dies during the grace period, the company is permitted to deduct overdue premium plus interest (the insurer normally does not charge interest) from the settlement with the beneficiary. The purpose of the provision is to protect the policyowner against unintentional lapse. If not for this clause, payments received even one day late could require new evidence of insurability to reinstate the policy. If your client paid a premium on the 29th day of the grace period, then died, the insurance would be in force. As

you can imagine, this important policy feature is accountable for saving more protection from being lost than any other single factor.

If there is cash value in a policy when it has passed the grace period limit, one of two things will happen: The automatic premium loan provision, if selected, will activate, or the policy will be moved to one of the nonforfeiture options (cash surrender, reduced paid-up, or extended term).

It is important to distinguish between the grace period and a late remittance offer. A late remittance offer is not a contract provision and is made at the insurer's option. It is not a right of the policyowner or an obligation of the insurer. It is an offer after the end of the grace period for the policyowner to send in the premium and reinstate the policy, without evidence of insurability. Conditions imposed on such an offer include that the insured must have been alive when the late premium was made.

**automatic premium  
loan (APL) option**

***Automatic Premium Loan (APL) Option***

The *automatic premium loan (APL)* provides that if a premium has not been paid at the end of the grace period, the company will automatically borrow enough money out of the cash value, if sufficient, to pay the amount due. The policy continues just as if the policyowner had made the scheduled premium payment. The APL creates a loan against the cash value that reduces its total amount and adds an interest charge on the borrowed amount.

If subsequent premiums are not paid, the company pays the premiums again out of the cash value. It will keep doing this until premiums are paid by the owner or the policy lapses due to insufficient cash value to pay the premium. Some companies limit the number of consecutive APLs (for example three) to prevent inadvertent depletion of cash value. Usually APL is an optional part of the contract and must be elected. Be sure you know whether this provision is included.

**reinstatement clause**

***Reinstatement Clause***

*Reinstatement* allows a policyowner to put coverage under a policy that has lapsed back into force. Lapsed policies may be reinstated (within a certain time frame, typically 3 years) if: they have not been surrendered for cash; proper evidence of insurability has been submitted and accepted by the company; and back and current premiums are paid, with interest. The company also may require that any outstanding policy loan be paid, with interest. Although the company usually reinstates the policy with a simple statement concerning the insured's health, a complete physical examination may be required at the company's option.

**Policy Loan Provisions****policy loan provisions**

The law requires that permanent life insurance has policy loan provisions enabling policyowners to borrow money from their policies (within certain limits) any time they wish.

Interest rates may vary up to a maximum set by state law. Most new policies have variable loan rates, replacing the fixed rate found in older policies. The money is available if the policyowner needs it, but advise him or her to exercise the policy loan provision wisely and with caution. Borrowing should only be done in an emergency, to take advantage of a significant financial opportunity or to discharge an important financial obligation. Indiscriminate borrowing can erode the protection provided by the policy.

A *policy loan* is different than a traditional bank loan, which requires repayment. A life insurance policy loan has no fixed or required repayment schedule, nor any obligation to repay the money taken from the policy. It is an advancement of the death benefit and is secured by the death benefit, or the cash value if the policy is surrendered or lapses. The amount of the loan plus any unpaid interest will be deducted from any policy proceeds payable upon surrender or death.

Why is loan interest charged? After all, it is the policyowner's money, is it not? The policyowner must pay loan interest on the "loan" because he or she has withdrawn assets from the insurer that were intended to support the level premium concept. In the initial calculation of the level premium, it was assumed that the money paid as premium would be invested by the insurer and earn a stated rate of interest. If the policyowner withdraws those assets, it is fair to expect him or her to pay an interest rate approximate to what the insurer would earn if the insurer had the money as assumed. Otherwise, the insurer would have to charge a higher premium.

**assignment provision****Assignment Provision**

Policyowners may assign the ownership of their policies to another person or institution by following company provisions for temporary or permanent transfer of ownership. Normally the policyowner must notify the company in writing of his or her intention to make an assignment. If the insured dies, the company will pay the death benefit to the new owner, the assignee, or the designated beneficiary if they differ. If the assignment is contested, the company will generally let the court decide who is to receive the proceeds. An irrevocable beneficiary of a policy must also agree to any assignment of the policy.

There are three ways that policyowners may assign or change the ownership rights to their policies.

- **Change of Ownership.** Through a legal form provided by the company, the right to control the provisions of the policy is assigned to another individual or institution.
- **Collateral Assignment.** Most conditional assignments of life insurance policies are made to facilitate the insured's credit to obtain bank loans. The assignment will give the lender rights to the portion of the policy assigned if the insured defaults on the loan repayment or dies before the legal obligations have been completed. The named beneficiary of the insured or the insured (if cash values were used) would receive any remaining value. When the legal obligation of the assignment is repaid, the insured regains all rights to the policy.
- **Absolute Assignment.** Under this arrangement, the assignee gets the entire amount of the insurance policy. This arrangement is also frequently used to secure a debt.

**misstatement of age  
clause**

***Misstatement of Age Clause***

Because of the importance of the insured's age in determining policy premium and values, any *misstatement of age* must be corrected once it is discovered. The company reserves the right to adjust the policy to the insured's correct age at any time. Different procedures are followed, depending on whether the mistake is discovered after the insured's death or while the insured is still living.

At death, if the insured is younger than originally shown in the policy, the amount of proceeds would be increased to an amount equal to what the premiums would have purchased at the correct age. If the insured is older than shown in the policy, the proceeds would correspondingly be decreased. If the insured is alive and is discovered to be younger than originally shown in the policy, the company may either adjust the premium downward and refund any money due the policyowner, or correct the amount of insurance by adjusting it upward in line with the premium. If the insured is older than shown in the policy, the company may either have the policyowner make up the difference in a cash payment and then pay the higher correct premium, or reduce the amount of insurance to match the amount of premium being paid.

***Nonforfeiture Provisions***

The level premium concept makes life insurance more affordable to older policyowners. In the earlier years of the policy, the level premium is higher than necessary in order to cover the mortality costs when the insured is older. The excess portion of the premium in the policy's early years, and the interest it earns, builds a cash reserve that is used to pay the mortality costs at older ages, which may exceed the level premium. Nonforfeiture laws state

that the policyowner is entitled to have the reserve set aside for the policyowner's future use.

These laws require insurers to provide policyowners with an option to voluntarily or inadvertently terminate their contracts and receive fair return of the value within those policies. Because the policyowner essentially paid premiums in advance, that person is entitled to recover them should he or she want them. They also require that after a cash value policy has been in effect for a minimum number of years (usually 3), the insurer must use part of the reserved excess premium to create a guaranteed minimum cash value.

**nonforfeiture  
provisions**

If a policy is terminated for any reason other than the insured's death, the *nonforfeiture provisions* allow the policyowner to receive the policy's cash value in one of three ways:

- **Cash Surrender.** The cash value may be received as a lump-sum payment, or the policyowner may elect to receive it as income under one of the settlement options offered by the company. This will be discussed later.
- **Reduced Paid-up Insurance.** Under this option, the cash value is used as a single premium on a policy of the same kind as the one being surrendered, except that the face amount is reduced. This is because the single premium is calculated on an attained-age basis and will not be sufficient to purchase the original amount at issue since no further premium payments are made. The policy cash values will continue to grow.
- **Extended-Term Insurance.** The cash value may also be used to buy extended-term insurance of an amount equal to the original policy's face amount. The extended-term option uses the cash value to purchase the same amount of coverage for as long a period as the premium can be paid by the cash value. When the term period expires, there is no more protection. The extended-term option usually goes into effect automatically if the policyowner does not elect one of the other options and has not asked for the automatic premium loan provision to be included in the policy.

Separate tables showing each of these provisions at different ages are provided in the policy. Review these provisions with your client. Point out the cash value in any of the years specifically mentioned in your life insurance proposal, such as at retirement or when the insured's children are in college.

**Exclusions in Life Insurance Policies**

There are several exclusions to policy benefit payments that might be found in a life insurance policy. Where an accidental death benefit is offered as the policy or as a rider to it, payment is restricted to the way that death occurred. This same situation applies to the suicide clause and incontestability clauses mentioned earlier. Other exclusions that may be added to a policy include death from hazardous occupations, hobbies, aviation, or physical impairments, as well as death resulting under the act-of-war clause or while committing a felony.

**Aviation Restrictions.** Restrictions are virtually universal on accidental death claims for all aviation-related deaths except for the insured passenger. At one time even the basic coverage payment was excluded, but with public acceptance of flying, companies instituted more liberal rules. All companies cover fare-paying passengers on regularly scheduled airlines. Passengers on unscheduled airlines, such as corporate planes, are increasingly being accepted without policy restrictions or increased premium rates. You should be thoroughly knowledgeable of your company's interpretation of aviation restrictions and use of an aviation questionnaire when you take an application. The latter will be used in underwriting some types of pilots and crewmembers. Depending on the type of pilot license, planes flown (especially ultra-light aircraft), and hours of flight, there could be an extra rate for coverage.

**Avocations.** Some hobbies and avocations are important underwriting considerations. In a few states where law permits, participation in a hazardous activity may exclude payment of death benefits if it is related to the claim. Hazardous activities include skin diving (to depths over 50 feet), mountain climbing, competitive racing, hang gliding, and skydiving. The underwriting process will reveal these activities; companies have avocation questionnaires for use when applicants indicate participation in these hobbies. Riders for extra premium could be required. Companies are interested in the insured's activities at the time of application, not in hobbies taken up after coverage is in force. This is a situation you may have to deal with occasionally. Prepare yourself on how to handle it before it comes up in an interview.

**War Clause.** Most contracts in the past have excluded full payment of proceeds to those in the military services during time of war. The purpose has been to control adverse selection due to the reality of increased mortality among those who buy insurance during these periods. The clause normally provides for a return of premium with interest or a sum based on the policy's reserve to the beneficiary. Be sure you know how your company handles the

war clause if a policy you deliver contains one. Under the status type of clause, the policy will not pay full benefits while the insured is in the military regardless of how death occurs. The more liberal clause, the so-called results wording, states that death must result from actual combat.

**Delay Clause.** Life insurance policies must contain a provision granting the company the right to defer payment of any cash value or policy loan (except for paying premiums) up to 6 months after the request is made for it. This provision is intended to protect the company against adverse situations where investments might have to be liquidated. This stems from the banking crisis during the Great Depression of the 1930s. It is intended to be used only under dire circumstances and is designed to protect the remaining policyowners as well as the company.

### **Dividends**

**The Divisible Surplus Provision.** Dividends are a valuable ownership provision of participating policies. Dividends are defined as a return of unearned premium. Companies include an additional margin in determining factors such as premium rates, mortality, and investment return.

If their experience is better than anticipated, the additional money may be returned to the policyowner in the form of dividends. Although dividend performance may be historically good, adverse mortality experience, decreasing interest rates, or periods of sustained inflation could have negative effects on dividend payments. You should discuss dividends in the most conservative terms and show the effect on the policy of a reduced dividend projection. Always emphasize that dividends are not guaranteed.

Instead of paying dividends, stock companies can offer lower premiums. This type of non-participating policy assumes the risk of higher mortality, decreased interest earnings, and increases in expenses.

**Dividend Options.** Dividends paid on participating policies are the policyowner's share of the company's divisible surplus. They are never guaranteed, are not part of the contract, and will vary based on actual experience of mortality, interest, and expense compared to original actuarial assumptions made in creating the policy.

There are five main dividend options. Dividends may be

- paid in cash
- used to reduce or offset premium payments
- used to purchase paid-up additional insurance
- left with the company to accumulate interest
- used to purchase one-year term insurance

The policyowner chooses an option at issue, but has the right to change this option at any time during the life of the contract. The dividend option that is in effect on the policy anniversary determines how the dividend will be paid that year, if one is paid. If the one-year term insurance option is selected, the insurance company may require proof of insurability.

Excess interest is the equivalent mechanism to a dividend found in nonparticipating and interest-sensitive policies. Excess interest and any other earnings are earmarked to provide an increase in the policy's cash value, to reduce the level of future premium payments, or both.

**Postmortem and Termination Dividends.** A postmortem dividend is payable at death and covers the period between the preceding policy anniversary and the date of death. A termination dividend is a special dividend that a company pays upon the termination of a policy through maturity, death, or surrender. These dividends may be a percentage of the policy's surrender value, face amount or reserve. The percentage will vary by plan and duration of contract. However, not all policies will have these types of dividends.

### **Policy Riders**

Formal descriptions of any riders included in the policy appear in the contract. Review each of them carefully; note any special purposes and definitions that may be confusing to your client. Three of the most common riders include:

#### **guaranteed insurability option (GIO)**

**Guaranteed Insurability Option (GIO).** The *guaranteed insurability option (GIO)* rider guarantees that the policyowner can buy additional life insurance in the future even if he or she should become uninsurable. Typically, additional life insurance in amounts equal to the face amount of the base policy may be purchased at 3-year intervals beginning at the insured's age 25 and extending to the anniversary date nearest the insured's age 40. Many companies offer options for additional purchase at marriage and at the birth or adoption of a child. When the option is exercised, the additional insurance premium is based on the insured's attained age at the time of each purchase. Generally, the insured has 90 days in which to exercise the purchase option at each of the purchase dates, but this may vary from company to company. The GIO is an especially important option for insureds whose life insurance needs will increase in the future, but who cannot currently afford as much protection as they will eventually buy.

**Accidental Death Benefit (ADB).** ADB usually provides an extra sum of insurance, equal to the face amount, if the insured's death is the result of an accident. Accidental death is strictly defined and usually excludes accidents

resulting directly or indirectly from any ailment or physical disability of the insured. Generally, ADB can be added at issue or after the fact (which may require evidence of insurability). Most companies do not offer new ADB after ages 55 or 60, and the benefit typically terminates after the insured reaches age 65 or 70.

#### ***Waiver of Premium***

Waiver of premium is a form of disability benefit that can prevent a policy from lapsing for nonpayment of premiums if the policyowner becomes disabled. In such cases, the company will waive the payment of premiums and keep the policy in force. Most policies specify that the insured must be totally disabled for the waiver to take effect. To qualify, the insured must be continuously disabled for a specific length of time, usually 90 days or 6 months. The insured must continue to pay premiums that come due during the waiting period, but those premiums will be refunded if the insured is disabled long enough for the benefit to begin. The company pays all premiums during the policyowner's disability. If the policyowner recovers and returns to work, regular premium payments are resumed. This benefit period will expire at about age 60 in most policies. Any clause providing benefits in force would continue, but no new claims would be honored. Premium for the rider is not charged when the benefit period expires. The waiver will normally not be granted if the insured's disability is self-inflicted or the result of war.

#### ***Settlement Options***

Policyowners may specify that their death proceeds be paid in cash, or beneficiaries may elect this payment form if the decision is left to them. Although a full cash payment is the most flexible of the payout options, a danger inherent in lump-sum settlements is that the money may be mismanaged, poorly invested, or spent foolishly, resulting in a serious loss to the beneficiaries. For these reasons—and because many surviving families need guaranteed income rather than cash—several other settlement options are available and may be selected by the insured or beneficiary. These options are discussed in detail in chapter 8.

#### ***Explain Provisions Carefully***

It is important that the advisor understands the product and can explain it to the applicant or policyowner. Interest-sensitive products such as universal life, variable, and variable universal life require special attention when you are reviewing provisions and features. For example, although many of the standard policy provisions discussed here are found in universal life policies,

many universal life features such as the coverage, death benefit option, premium, cash accumulation account, monthly deduction, interest crediting, partial withdrawals, and surrender all differ from company to company and product to product. These need to be carefully explained.

When you sell a product, it is your obligation to know the details of your product's features and provisions in order to clearly explain them to policyowners. Many permanent policies will require attention to the cash value performance in future years, and your policyowners need to understand their responsibilities and the future options they will encounter.

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## **THE INCOME AND ESTATE TAXATION OF LIFE INSURANCE**

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Historically, life insurance has been considered beneficial to the public good because it contributes to the financial preservation of families. Because of this, certain tax benefits are provided for life insurance products.

There are many features of the life insurance contract that provide potential tax benefits to a policyowner or beneficiary. Many of these features are not found in other financial contracts, and none can claim all of them. It is not proper to purchase life insurance contracts because of the tax advantages alone, but when considering these benefits in addition to others found, the life policy has a combination of benefits of considerable worth.

Many of your prospects will have questions about the taxation of personal life insurance policies. Frequently asked questions include:

- “Are life insurance premiums tax deductible?”
- “Will my children have to pay income tax on the proceeds from this policy?”
- “Do I have to pay income tax on the dividends you told me about?”
- “Is this life insurance going to be included in my estate and subject to estate tax?”

To help you with these questions, this discussion will summarize the main points of federal income and estate taxes for both life insurance death proceeds and the living benefits of a life insurance contract.

### **Income Taxation**

#### ***Premiums***

Premiums paid for individual life insurance policies in the United States are usually considered a personal expense and are not deductible for income tax purposes. However, there are exceptions to this.

- Premiums paid for life insurance in an alimony agreement may be deductible.
- Premiums paid for life insurance that is owned by a charity and proceeds that are paid to a charity as beneficiary may be deductible as a charitable contribution.
- In business situations, employers are allowed to deduct premiums for life insurance protection if paid in the form of a bonus to the employee. The employer may then deduct the amount of the bonus as a business expense.
- If life insurance is part of a pension plan, the premiums are deductible as part of a contribution by the employer to a tax-qualified plan.

### ***Death Benefits***

Generally, death proceeds from a life insurance policy are exempt from income taxation when paid in a lump sum. This is because Congress recognizes that life insurance ownership achieves a social purpose and should be encouraged. There are some exceptions to this general rule, and not all state income tax laws follow the lead of the federal tax laws.

***Accelerated Death Benefits.*** Amounts received under a life insurance contract covering the life of an insured who is terminally or chronically ill are excludible from income as amounts payable by reason of the death of the insured if certain conditions are met. Terminal illness must be certified by a physician, and the illness or condition typically must be expected to result in death within 24 months of the certification.

***Transfer for Value.*** One exception to the general rule of income tax-free death benefits is encountered when a policy has been transferred from one owner to another in exchange for valuable consideration (something of value—usually money). A part of the proceeds would be subject to federal income tax. The taxable amount is the difference between the face amount and the amount paid to transfer the policy from one owner to another, and the premiums made by the new owner. Details of this rule will not be covered here, but keep in mind that this type of transfer could negatively affect income taxation of policy proceeds.

Certain transactions are exempt from the transfer for value rule, including situations where the policy is sold to the insured. This situation is often found in business applications of life insurance used to insure employees, partners, officers, and others. Another exception is when the policy is a bona fide gift.

### **Cash Values**

**Matured Life Contracts.** Another exception to the tax-free treatment of policy proceeds is when the policy benefit becomes payable during the insured's lifetime because he or she has reached the maturity date specified in the policy. The proceeds would not be considered a death benefit, and any gains in the policy would be considered ordinary income for the tax year in which they are distributed.

**Dividends.** The cash dividend is taxable only when all dividends paid exceed the amount of premiums paid into the policy. Dividends are generally taxed on a *first-in first out (FIFO)* basis; that is, dividends (and withdrawals) are treated as a nontaxable return of capital (refund of premiums) to the extent of premiums paid. Withdrawals in excess of premiums paid are taxable as ordinary income. LIFO or *last in first out* means that gains (interest, profits, earnings) are recovered before contributions. These are known as the *cost recovery rules* of the Internal Revenue Code.

If dividends are withdrawn or the policy is surrendered, a calculation is made to determine if proceeds received are in excess of premiums paid, resulting in ordinary income tax being due on any excess amount. For this reason, as well as others, paid-up addition is the generally recommended dividend option.

If a policyowner chooses not to receive the dividends in cash, but allows the dividends to accumulate at interest with the insurance company, the interest earned on the dividends is subject to taxation as interest income. Interest payments on the dividends are treated the same as interest on any type of savings account.

**Loans.** The loan provision gives the policyowner the right to borrow a percentage of the cash value that has accumulated in the policy. If a policy is surrendered with a loan outstanding, and if that loan, with other cash value, is greater than the cumulative premium payments made, there will be a taxable gain on the difference.

**Cash Surrenders.** To determine if income tax is due on the surrender of a policy for cash or at the maturity of an endowment, it must be determined if the amount received from the policy over the life of the contract exceeds the net premiums paid. *Net premiums paid* means the gross premium less any dividends or cash withdrawals received, and less any outstanding loans. This is called the cost basis, meaning the amount the policyowner paid with after-tax money. The total net premium is then subtracted from the amount of cash the policyowner receives upon surrender or maturity. Any excess is reportable as ordinary taxable income in the year received. Premiums paid for supplementary benefits such as waiver of premium or accidental death riders are not included in the cost basis.

**Sec. 1035 Policy Exchanges.** When a policyowner exchanges an existing policy for a new one and does so in accordance with the Internal Revenue Code guidelines of *Sec. 1035*, no gain is attributed on the exchange. The adjusted basis of the old policy is carried over to the new one. Only the newly added premium will be measured for MEC status. A *Sec. 1035* exchange is allowed only when transferring cash values from an annuity to an annuity, life insurance to life insurance, or life insurance to an annuity contract. The new policy must retain the same insured and policyowner as the original policy.

**modified endowment  
contract (MEC)**

**Modified Endowment Contract (MEC).** The modified endowment contract or MEC came into being with the 1988 amendment to the tax code (TAMRA, IRC Secs. 72 and 7702A). Prior to this time, people were putting large sums of money into life insurance contracts so they could accumulate funds on a tax-deferred basis. This was contrary to the tax viewpoint that life insurance was to be used primarily to provide a death benefit. TAMRA provided that if a policy was overfunded (whether at issue or at a later date), it would be classified as a modified endowment contract, and as a MEC, any distribution representing a gain from the policy would be taxed.

To determine if a policy should be classified as a MEC, the 7-pay test is applied. This establishes limits to the amount of premiums that can be paid into a life insurance policy within a period of 7 years. If the policy was overfunded, it would become a MEC. "Material changes" that occur to a policy once it is in force will cause the policy to be retested. The rules apply as if the changes existed since the beginning of the policy. Your home office should be able to guide you on the classification of a policy as a MEC in these situations.

If a policy is or becomes a MEC, it is treated the same as any other life insurance policy, with one exception. Distributions or withdrawals any time before death are treated like premature annuity or individual retirement account (IRA) distributions, on a *last-in, first-out (LIFO)* tax basis to the extent there is gain in the policy. Under the interest-first rules, any distributions from a MEC are taxed as income first and recovery of basis second. In addition, the taxable gain will be subject to a 10-percent penalty unless the distribution is made after age 59½ or death, disability, or annuitization occur.

Distributions from a MEC include:

- policy loans (including automatic premium loans)
- cash dividends
- withdrawals
- surrenders

If a policy becomes a MEC, it is tainted for as long as it exists. The taint carries over to any policy that is issued in exchange for a MEC, even if the new contract normally would not be classified as a MEC. This means that care must be taken when making a 1035 exchange.

A Sec. 1035 exchange (tax-free exchange where one policy is exchanged for another if certain rules are met) is a material change for purposes of the MEC rules. According to the IRS, the policy received in exchange will be treated as a newly issued policy with a new 7-year period beginning on the date of exchange. The new policy must be tested under the 7-pay test rules. Cash values transferred from the existing policy will not count as premium. If the policy fails the material change test, it will be classified as a MEC. Once again, look to your home office for guidance on these situations.

### **Estate Taxation**

Because the federal estate taxation of life insurance is complex, this is only a brief review of some of the major issues. Although the death benefits of a life insurance policy are generally free of income taxation, they can become includible in an insured's estate and subsequently subject to federal estate tax and estate administrative expenses. There are three basic instances when life insurance is included in a decedent's gross estate:

- when it is payable to the insured's estate
- when the insured possessed incidents of ownership in the policy at the time of death
- when the insured transferred incidents of ownership by gift within 3 years of death

### ***Proceeds Payable to Estate***

probate

Life insurance proceeds are not generally part of the *probate* estate, which involves the passing of the will through the local court system where the deceased lived. Life insurance proceeds pass by provision of contract directly to the beneficiary, bypassing probate. Because of this arrangement, the proceeds can be paid promptly to the beneficiary, without the delay caused by administration of the estate. There is no public record of the death benefit amount or to whom it is payable. The proceeds become a part of the probate estate if they are paid to or for the benefit of the insured's estate.

Life insurance proceeds payable to the executor for the benefit of an insured's estate are includible in the estate, regardless of who owned the contract or who paid the premiums. There are many reasons (in addition to avoiding federal estate taxation) why insurance advisors seldom recommend that life insurance be payable to a decedent's estate:

- Insurance payable to a decedent's estate subjects the proceeds to the claims of creditors.
- Insurance payable to a decedent's estate subjects the proceeds to costs of probate administration and possible estate taxation.
- In many states, life insurance proceeds that are otherwise exempt from state death taxes (either fully or partially) if payable to a named beneficiary become subject to such taxes if they are payable to the insured's estate.

#### ***Possession of Incidents of Ownership***

##### **incident of ownership**

A life insurance policy is included in an insured's estate if he or she possessed an *incident of ownership* in the policy at the time of death. An incident of ownership is broadly defined as any right to the policy's economic benefits. When insurance proceeds are paid to a named beneficiary other than the insured's estate, incidents of ownership in the policy at the time of death are the key criterion for inclusion. The regulations provide that incidents of ownership include (but are not limited to) the power to

- change the beneficiary
- assign the policy
- borrow on the policy
- surrender the policy
- exercise any other essential contract rights or privileges

To remove life insurance proceeds from the reach of federal estate tax, the insured must divest himself or herself of all significant rights and privileges under the contract.

#### ***Transfers within 3 Years of Death***

Life insurance is included in the gross estate of an insured who transferred incidents of ownership in the policy by gift within 3 years of his or her death. Transfers made more than 3 years before the insured's death are not includible in the insured's estate, assuming the insured has retained no incidents of ownership.

If estate inclusion and tax is a potential issue, a policy on the estate owner should be owned from its inception by a third party. This third party should pay all premiums because inclusion may result if premiums are paid from funds provided by the insured. If a trial or preliminary application is used to determine if the prospect is insurable, it is best to have a trust or another third party be the applicant. Check with the insurer's procedures and the treatment under the laws of the local jurisdiction.

### Summary

The purpose of this brief review of federal taxation of life insurance is to alert you to the questions your prospects and clients may ask, and to appreciate the importance of the proper implementation of an insurance policy. It is not definitive, so you should not give tax advice based on this information. When a client believes that a personal tax problem might result from the use of life insurance, the client should consult his or her own tax advisor. Your company may be able to help you in specific cases.

You may depend upon your life insurance company to provide the client with accurate information when any notice of taxation is sent. Ask your agency for further information about the taxation of the products you sell.

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### AN ADVISOR SPEAKS: WHAT'S A TEAR WORTH?

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*Paul R. Jeffers, CLU, ChFC, wrote this article for LUTC several months before he died. He was a well-known national figure who spoke about the sale of life insurance to groups in every state and from the main platform at MDRT. He was a past president of California's ALU as well as his own Sacramento association and served as a national committee chairman.*

When I began selling life insurance about 40 years ago, I came across an advertisement in one of the magazines of the day. This ad was for tombstones and covered two pages back-to-back. The first page showed a picture of the front of the tombstone, facing the lettering. A small boy, about 8 or 9, stood with his back to the camera, facing the tombstone. He wore a Cub Scout shirt, a hat, and an old pair of scruffy jeans. Just over the little boy's shoulder, you could read the word "Daddy" carved on the tombstone. As you turned the page, the same scene was photographed on the reverse page, but from the opposite direction. It showed the back of the tombstone and the little boy's face. This picture showed the boy giving the tombstone his Cub Scout's salute as a big tear rolled down his cheek. The caption read, "What's a Tear Worth?"

As I looked back and forth between these pages, suddenly I realized that this was an ad about life insurance, not the sale of tombstones. That father's dreams for this little boy's life rested with the plans he had made in the past. Had he protected his family's future? Would dreams of home, education, and the pleasures of growing up in a loving, sheltered environment be there for this young boy? Was this the tear of sorrow or of desperation?

If that father could do it again, how much life insurance do you suppose that tear would mean to him? Don't you think that he would buy all the life insurance he could afford and then some? I think he would. As I have

thought about this ad with the tombstone over the years, I have been inspired again and again to urge my clients to buy all the life insurance they could afford. There is but one life for each of us to insure. None of us knows how long it will last, and there is no second chance. As an advisor, I have felt the obligation never to miss the opportunity to push for the maximum protection a family could be provided by a policy the family's breadwinner(s) purchased.

I believe I know what our life insurance product is. It is, in fact, the greatest language of love ever known. Let me give you a couple illustrations to show you why I believe this to be so.

Not long ago, I delivered a death claim check of \$800,000 on a 42-year-old doctor who went out one morning for his usual 5- to 6-mile run. He came back to the house after running and walked into the kitchen to say something to his wife. He fell to the floor with his head on her slipper. He was dead! He had an aortic aneurysm and had died instantly. He left his widow and two children with the \$800,000. His practice that had been paying him \$436,000 per year was sold for \$0. The widow didn't get a nickel for it. Do you know why? The other doctors told her, "Why should we buy it? Those people have to come to us anyway."

The widow had a house that was paid for and the \$800,000 in a trust. This money in trust was given to her as monthly income. With every check, that doctor told his widow, "I love you."

I delivered another check to a friend of mine who lost his 54-year-old wife to cancer. I laid the \$200,000 check on his office desk. He started crying and so did I. After he regained control, he told me the following: "Paul, do you remember the trouble I gave you when you sold this policy to me? I told you it was the dumbest thing I could do."

He continued, "You persisted and I probably bought it just to get rid of you. Paul, let me tell you this: If I did not have this insurance money right now, I would lose everything I have. My business would be gone and I would have to start over. Your insurance policy is keeping me from going bankrupt and, thank God, you kept after me to do something that I should have done without any urging. *You saved my business and my life.*"

So, what is a tear worth? If you don't have life insurance, is it worth the suffering your family will go through because you just didn't have enough sense to buy adequate amounts when you had the chance?

I like to think that life insurance premiums are always paid, either during your lifetime by paying for a life insurance policy, or at death by the family doing without those things that are so important to them. Which way is the best way? I spend my life helping people decide what the worth of that tear really is.

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**CASE HISTORY: LIGHTING THE FIRE**

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*C.W. Girard, LUTCF, CLU, ChFC, has been an insurance advisor for 25 years in a large Midwestern community. He related this story about the experience he had as young agent that awoke him to the true value of life insurance. It was a policyowner's death that made him into a salesman.*

**My Frame of Mind**—I awoke early and went for a long walk to get some exercise before my family woke. My early morning walks have always been one of my stress relievers—they give me a chance to get out and think through the things on my mind without distractions.

**Shocking News**—When I returned home, my wife met me at the door, almost in hysterics. In a halting voice, she told me that Kathy—one of our closest friends—had died suddenly, unexpectedly, during the night. Kathy's father-in-law had called and asked that I come over as soon as possible.

After my wife assured me she was all right, I drove to Kathy and Dave's home. I was met at the door by Dave's father. He told me Dave was at the hospital and would be home soon. He wasn't sure what had happened to Kathy—perhaps an aneurysm or stroke while she slept. Everyone was in a state of shock.

**Remembering the Sale**—The next few days passed in a blur. I thought often of Kathy and Dave, and their three children. They were among my first clients and I'm sure their first purchases were made with more concern for my welfare than theirs. I remembered Kathy laughing when we wrote up her first policy—\$250,000 term—when I called it “a small one.” We converted part of it 2 years later, but that was all the coverage she had in force. At her funeral, I cried for all the usual reasons and some special ones too, knowing Dave would have enough money to take care of the kids' college education.

**Help From the Agency**—I talked with my manager about how to file the claim before I worked up the courage to talk with Dave. My manager told me to wait a few days, and just be a friend for now. Three days later she called me into her office and had a settlement check for me—she had called the home office to explain the circumstances, obtained a copy of the death certificate from the funeral home, faxed a copy of the obituary from the paper, and took care of the paperwork for me. She suggested I meet with Dave, hand him the check in a sealed envelope, and simply offer to help when he was ready.

I went to Dave's home that afternoon and found him there with his dad. They were looking at old photo albums and talking of Kathy and also Dave's

mother, who had passed away several years before. After looking at the photos, the kids came home from school. Following a hug and a snack, Dave's dad said he would take care of them for a while so we could talk.

**Help From the Beneficiary**—I didn't know what to say, but Dave made it easy for me by asking if I had paperwork for Kathy. I nodded and handed him the envelope. "I know we can't bring Kathy back, but she wanted you to have this. I suggest for now you put this into a money market account, and we can talk some more when you are ready." He agreed, signed a form, took my hands in his, and said, "Thank you."

Three months later, I reflected on the events that had happened. Dave did invite me over after a few weeks passed. He asked about investments for college, and I suggested a mix of mutual funds. He wrote a check for most of the settlement proceeds immediately. I mentioned also that this might be a good time to review his life insurance coverage and look at converting his term policy. For premiums, he could use some of the interest and growth from the investments, and the growth in cash values would be available for college or retirement, too. Dave liked this idea and then mentioned his dad wanted to talk to me. Asking if there was anyone else who might be able to benefit from my services, he brought out his address book and gave me 21 more names and told me to use his name. Never had a client been so willing to help me.

**What I Learned**—I learned a great deal from the loss of my friend. It was the first time I had experienced the death of someone my own age, someone I knew so well. It made me appreciate life even more. My wife and I grew closer than we ever had been, and we made a real effort to spend more time together with our family. We saw first-hand how life insurance can help, and my commitment to the business became stronger than ever before.

**The Outcome**—I am also closer to my associates at the office, many of whom have heard me relate over and over how much we help people when they need it the most. Our ties with Dave and his family are closer than ever before, too. He was able to take time off to be with his family and not worry about money. Kathy's dream that the children attend college is still alive. I know, too, that the next time I get discouraged, I will remember my friends Kathy and Dave, and I will persevere to help others help themselves.

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**CHAPTER REVIEW**


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*Key Terms and Concepts are explained in the Glossary. Answers to the Review Questions and Self-Test Questions are found in the back of the textbook in the Answers to Questions section.*

**Key Terms and Concepts**

total needs approach	unilateral contract
client-focused selling/planning approach	aleatory contract
needs for life insurance	contract of adhesion
income needs	policy date
readjustment period	incontestable clause
dependency period	grace period provision
blackout period	automatic premium loan (APL) option
cash needs	reinstatement clause
final expenses	policy loan provisions
emergency fund	assignment provision
human life value	misstatement of age clause
future value	nonforfeiture provision
present value	guaranteed insurability option (GIO)
law of large numbers	Sec. 1035 policy exchange
mortality, interest, expense	modified endowment contract (MEC)
National Association of Insurance Commissioners (NAIC)	probate
2001 Commissioners Standard Ordinary (CSO) Mortality Tables	incident of ownership

**Review Questions**

- 1-1. How can life insurance provide a solution for the economic loss of a breadwinner?
- 1-2. What is the concept of human life value and how does it relate to life insurance?
- 1-3. What are the benefits of life insurance?

- 1-4. What are the general insurance principles that are the basis for life insurance?
- 1-5. Explain the three elements that are the building blocks of a life insurance policy.
- 1-6. How can mortality tables be used to predict mortality and life expectancy?
- 1-7. What is the importance of the policy provisions to a life insurance contract?
- 1-8. Define the following policy provisions:
  - entire contract
  - incontestability
  - automatic premium loan
  - reinstatement
  - assignment
  - nonforfeiture options
  - policy loan
- 1-9. What are the general income and estate tax rules that apply to individual life insurance policies?

### Self-Test Questions

*Instructions: Read chapter 1 first, then answer the following questions to test your knowledge. Circle the correct answer. When finished with the test, check your answers with the answer key in the Answers to Questions section..*

- 1-1. The national organization that offers model regulations to the individual states to provide uniformity to insurance regulations is
  - (A) LUTC
  - (B) NAIFA
  - (C) SFSP
  - (D) NAIC
- 1-2. When the premium for Irene's life insurance policy was still unpaid at the end of the grace period, what action would the insurance company have taken on her 10-year-old whole life plan with \$8,000 cash value and the APL (automatic premium loan) option?
  - (A) cancel the policy
  - (B) surrender the policy for the \$8,000 cash value
  - (C) advance the premium payment automatically as a loan from the \$8,000 cash value
  - (D) move the policy to an extended term plan under the settlement options

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- 1-3. If the insured is found to be older at death than was stated in the application for an insurance policy, the company will
- (A) do nothing
  - (B) refund all premiums
  - (C) increase the coverage amount to what the premiums would have purchased
  - (D) decrease the coverage amount to what the premiums would have purchased
- 1-4. A man purchases a \$100,000 whole life policy. Many years later, he surrenders the policy for its cash value of \$50,000. At that time, he had paid \$45,000 of premiums and received dividends of \$10,000. What were the income-tax consequences upon receipt of the cash surrender value?
- (A) He received the entire \$50,000 tax free.
  - (B) He received \$45,000 tax free and \$5,000 as long-term capital gains.
  - (C) He received \$15,000 tax free and \$35,000 as ordinary income.
  - (D) He received \$35,000 tax free and \$15,000 as ordinary income.
- 1-5. The human life value approach assumes that a person's economic value is an amount equal to the
- (A) capitalized value of a person's gross future earnings
  - (B) capitalized value of the person's net future earnings
  - (C) needs of the family if the person should die
  - (D) life income needs of the surviving dependent spouse
- 1-6. Which of the following investments accounts for the largest share of assets of U.S. life insurance companies?
- (A) bonds and mortgages
  - (B) policy loans
  - (C) stocks
  - (D) real estate

- 1-7. Dividends paid to the policyowner are generally
- I. Taxed on a FIFO (first in, first out) basis.
  - II. Taxed at capital gains rates because they represent a return of capital.
- (A) I only  
(B) II only  
(C) Both I and II  
(D) Neither I nor II
- 1-8. All of the following would cause inclusion of a life insurance policy in the estate of the insured EXCEPT
- (A) the beneficiary of the policy is the insured's estate  
(B) the insured possessed incidence of ownership in the policy at the time of death  
(C) the policy was owned from inception by the insured's spouse and she paid all premiums  
(D) the insured owned the policy but transferred it to his spouse within 3 years of his death
- 1-9. All of the following are correct regarding family life insurance needs EXCEPT
- (A) The dependency period extends from the insured's death until the youngest child is self sufficient.  
(B) The readjustment period is the interval of time after the insured's death and the surviving spouse's retirement  
(C) The blackout period lasts from the youngest child's 18<sup>th</sup> birthday until the surviving spouse is aged 62.  
(D) Cash needs include final expenses, emergency fund, and mortgage cancellation.
- 1-10. If a policy becomes a modified endowment contract (MEC), taxation of all of the following may be affected EXCEPT
- (A) withdrawals  
(B) loans  
(C) death benefits  
(D) surrenders

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