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## The Basics of Life Insurance

In selecting a life insurance product for their clients, insurance producers must consider the need(s) that the **applicant** is trying to meet: providing replacement income for survivors, extinguishing debt, funding education, providing for special needs beneficiaries, creation of an estate, payment of estate settlement costs (federal and state death taxes, last illness and burial costs, or probate fees), business buy/sell, or key-person coverage.

Life insurance offers a way to replace the loss of income that occurs when someone dies. The insured is usually a contributor to household income and/or responsible for homemaking and/or childcare. A life **insurance policy** is a contract between an individual (as the insured person) and the insurance company or “carrier” that is providing the insurance.

A good life insurance program does more than just replace the loss of income that occurs if the insured dies. It should also provide money to cover the new costs that arise after the insured’s death, such as funeral expenses, taxes, probate costs, the need for homemaking and childcare, and so on.

Life insurance can be a unique wealth creation tool that provides the needed amount of tax-free liquid capital upon death. Depending on the plan of insurance, it may also create capital for lifetime needs.

Life insurance costs can vary greatly based on the age and health habits of the **policyowner**, the amount of insurance purchased, and the type of policy chosen. A life **insurance policy** may afford greater **indemnity** when the death is accidental. When insurance pays out twice the **face amount** of the original policy upon an accidental death, the coverage is known as double indemnity.

### A. The Basic Definition of Life Insurance

A working definition of **life insurance** begins with understanding why the concept of insurance originally developed. In all lives, uncertainty exists about what will happen tomorrow, next month, and next year. The future holds unknown events; some will be positive, and others will be negative. Negative events include the possibility of loss. Insurance is specifically concerned with financial loss.

*For example*, because most people own and rely upon the availability of cars, they can envision the financial loss that will occur if the car is damaged in an **accident**. As a result, people buy auto insurance to protect themselves against the uncertainty — the risk they take by driving — that they will suffer a financial loss if an accident occurs.

Life insurance is designed to protect against the risk of death. The risk of death exposes a family or a business to certain financial risks, such as burial expenses, paying off debts, and loss of family income and/or business profits. Different types of life policies exist specifically designed to meet unique needs of the insured and their beneficiaries. An individual has the opportunity to shop all the best insurance companies to obtain the maximum coverage at the best insurance value.

That is not the only aspect about life insurance that is important, however. It is of utmost importance for an individual to evaluate his or her particular circumstances in life. What are the client's plans? Is he or she fresh out of college or raising a family? On the other hand, individuals may be mid-40s or mid-50s when they shop for life insurance. The needs at that time would be considerably different.

## B. Meeting the Client's Needs - The Basic Purposes of Life Insurance

### 1. Paying Death Benefits

The best understood and most obvious purpose of life insurance is to pay a **death benefit** to survivors when the insured person dies. Paying death benefits was the original purpose of life insurance policies and continues to be the major reason people buy life insurance. Life insurance paid at the time of death can be used for many purposes, including the following:

- Providing ongoing living expenses for survivors;
- Retiring a mortgage on the survivors' home;
- Establishing a fund for children's future college costs;
- Paying off other debts when the insured person dies;
- Paying death expenses, such as medical and funeral costs;
- Buying out a surviving partner's interest in a business; and
- Replacing income lost by the death of a key employee.

Although those are traditional uses of life insurance, contemporary policies can provide additional benefits, whether the insured person lives or dies.

### 2. Major Classifications of Life Insurance

#### Term Life Insurance

A **term insurance policy** provides life insurance coverage for a specified period (or term) usually expressed in years. Term insurance policies are issued for a period or "term" of between 1 and 40 years in duration and most provide the insured the guaranteed right to renew into a subsequent term at guaranteed rates without evidence of **insurability**.

Premiums for term insurance remain level for the term of the contract (1 year, 5 years, 10 years, up to 40 years) and will increase for each successive term of coverage. Term insurance comes in several different varieties, which will be discussed throughout the remainder of this course.

#### Cash Value Life Insurance

**Cash Value** or **Whole Life Insurance** is sometimes called whole life because, unlike term insurance, premiums generally remain level for the insured's entire life (whole life). For the purposes of this course, we will use the term Cash Value to denote this type of coverage because the existence of cash value is what separates this type of coverage from term insurance. To keep the premium rate level in cash value insurance, the premium in the early years of the policy is higher than the actual cost of protection.

Part of this extra premium builds a cash reserve that helps to pay for the policy in later years as the cost of protection rises.

The insurance company invests these cash values to build a reserve to offset the increased cost of insurance in the latter years of the policy. Some cash value policies guarantee a minimum growth rate on the accumulation of cash values and some cash value model policies do not guarantee future cash values. Most policies built on the cash value concept pay only the **death benefit** when the insured dies, but some policies built on the cash value model pay both the death benefit and the accumulated cash values when the insured dies. Like term insurance, cash value policies come in several different varieties which will be discussed throughout the remainder of this course.

Now that we have a basic understanding of the two main categories of life insurance, we will explore what all life insurance policies (term and cash value) have in common to better understand the differences and how these differences impact product structure and price.

### Mortality Assumptions

Mortality assumptions are at the core of all life insurance policies, whether they are term or cash value policies. These mortality assumptions are based on the mortality tables prescribed by regulators.

States require that when reserving for a life **insurance policy**, the insurer must use the 1980 Commissioners Standard and Ordinary Mortality Tables, unless the Commissioner or Director of a state decides to require the use of a newer table locally.

In addition, the reserve valuation method is prescribed by law. The requirements of the **legal reserve** system of insurance laws are designed to ensure that insurers reserve a sufficient amount in their legal reserve accounts to actuarially meet policyholder obligations.

### Reserve Requirements

When calculating required reserve amounts, the actuaries must focus on the net amount at risk for a particular policy. The net amount at risk should reflect how much risk the insurance company is assuming for a particular policy.

Since the mortality tables dictate the mortality assumptions that must be used when determining reserve amounts, we will use a few simplified examples of how these tables affect required policy reserves.

### Sample Mortality Rates

Below is a section of the 1980 Commissioners Standard and Ordinary Mortality Tables showing the mortality rate for all male nonsmokers (ages 35 through age 44).

#### 1980 CSO Male Nonsmoker Mortality Rates

Age (nearest birthday)	Mortality per 1,000
35	1.69
36	1.77
37	1.88
38	2.00
39	2.14

40	2.29
41	2.47
42	2.65
43	2.86
44	3.07

These mortality tables numerically express years of actual mortality experience and allow insurance companies to accurately predict losses in a population of individuals who all represent a similar risk.

### Risk Pooling

Insurance companies employ actuaries who use these mortality tables and statistical calculations to effectively pool risks together. *For example*, if 100 people all face a 1% risk of dying in a given year, then statistically, one person will die within the population of 100. Common sense would dictate that if each of the 100 people were to contribute \$1 to a risk pool, they could afford to insure all 100 individuals for \$100 each, effectively insuring the 1 out of 100 that is expected to die. However, if 2 people out of this population were to die, the risk pool would not be able to pay a \$100 **death benefit** to the second person who dies.

Statistics show that as long as risks are similar, the more risks pooled together, the more accurately losses can be predicted. If we follow the same example as above, but assume that 10,000 people with a 1% risk of dying in a given year pool their risks together, we are much more likely to experience loss results within the expected range of 100 deaths ( $10,000 \times .01$ ).

This risk pooling process is often referred to as “the law of large numbers” or “the law of averages” and helps insurance companies accurately predict losses and determine the appropriate premium to charge.

### 3. Cash Accumulation

As life insurance policies evolved, more emphasis was placed on the cash values that accumulated in policies as premiums were paid. Certain policies have features allowing cash accumulation that may be used by the insured person who does not die. *For example*, a policy might accumulate cash values that would be payable to the **policyowner** when he or she reaches a certain age or after the policy has been in force for a specified number of years.

A cash value life **insurance policy** builds guaranteed or nonguaranteed cash value, depending on the type of life insurance purchased. This cash value builds as the **policyowner** pays premiums. These values are further enhanced, since taxes on the money's growth are deferred. This cash value can be accessed through a loan provision. If the insured of a cash value life insurance policy dies while a policy loan is outstanding, the loan balance is subtracted from the **death benefit** paid to the beneficiary.

The **policyowner** can borrow from the policy's accumulated cash value by taking a loan at competitive interest rates. The policyowner can use these funds in any way that he or she wishes, such as making a down payment on a home, financing a new car, or even starting a business. The loan privilege is a characteristic cash value life insurance, but the policyowner must remember that borrowing against the policy's value reduces the insurance protection.

Note: Cash value insurance is a broad heading used for any type of life insurance that accumulates cash values and can take many policy forms. Cash value life insurance is sometimes referred to as **permanent life insurance**.

## 4. Estate Building or Conservation

A life **insurance policy** can provide for the income needs of surviving dependent family members. Whether this means children or a spouse, there will be a need for cash stabilization. A life insurance **death benefit** can also pay federal and state death taxes and other estate settlement costs. It can be used to pay debts, to provide for children's education, or to meet special financial demands of physically or mentally handicapped/learning-disabled children, parents, or other dependents with physical or mental limitations.

Another principal use of life insurance is to shift wealth from one generation to another in the most cost-effective manner, and can also be used to relieve survivors of financial management burdens by providing an inexhaustible lifetime annuity.

Life insurance policies can also create an instant estate to benefit a charity. Making a financial gift to a favorite charity is a goal shared by many people. A substantial gift during one's lifetime may seem to be out of reach, but a **policyowner** will be able to do just that using life insurance. This is an overview of the many areas for which a life **insurance policy** can be used and can cushion the lives of many people.

## C. The Basic Uses of Life Insurance Policies

The main use of life insurance is to protect a family or dependent from the premature death of an income contributor. An insured individual who has a spouse and children depending on his or her income may need to consider other situations in his or her life that are in need of security. If there are business associates who depend on a key person for the operation of the company, the firm may need to insure his or her life for the future of the business.

The last thing that family members or business associates need to worry about is coping with the financial consequences of an untimely death. Without the breadwinner, a family may not be able to meet mortgage payments, provide for college expenses, or prepare for retirement. Immediate and future family needs may need to be put on hold as a result of death, whether untimely or not, just as business operations could be turned upside down.

### 1. Death Benefits

When traditional types of life insurance are written with a certain **death benefit** – let's say \$100,000 – the **face amount** of the policy remains in effect as long as the **policyowner** pays the premium. However, if the policyowner doesn't pay the premium, the insurance can end. One important feature of some life insurance policies is that the death benefit is adjustable. It could be \$100,000 at the beginning of the **policy period**, but it might drop down to \$50,000 at some point and later rise to \$175,000. Within certain limitations, the policyowner controls these adjustments.

### 2. Replacement Income

A life **insurance policy** can replace income for the survivors during a readjustment period of 2 or 3 years after the policyowner's death. If the family is a two-income family, it takes time to adjust to one paycheck instead of two. If the policyowner is the sole wage earner, and has young children at home, the spouse's need for a readjustment period is obvious.

In general, determining how much life insurance an individual needs means deducting the sum total of the income that would be lost upon the insured's death from the sum total of the family's ongoing financial need. It also means calculating the impact of inflation and building in enough "extra" to counteract inflation's effects.

### 3. The Use of Life Insurance with Home Mortgage Loans

Policyowners can purchase life insurance to provide the cash needed to pay off a home mortgage if the breadwinner dies. To accomplish this, a [policyowner](#) can purchase a decreasing term policy for the same amount as the original mortgage. The term policy is designed to decrease as the mortgage principal is paid down.

Another alternative is to purchase a level cash value life [insurance policy](#). The idea is that the cash value increases as the mortgage decreases. When the cash value reaches the same amount as the mortgage, the policyowner can use it to pay off the mortgage early.

Another concept is to buy additional amounts of life insurance in your personally owned life insurance plan to pay off the mortgage and consider accelerating the mortgage by paying an additional amount of principal with each mortgage payment.

Both of these approaches would pay off the mortgage at the death of the insured and will also facilitate the early payoff of the mortgage if the insured lives.

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## Understanding Needs Analysis

### A. Quick Facts

Here are some interesting statistics compiled by the American Council of Life Insurers in their 2011 Fact Book (the numbers are provided for 2010):

- Americans purchased \$2 trillion of new life insurance policies, which was 3% less than the year before;
- The average **face amount** of life insurance policies was about \$166,000;
- 39% of new individual life policies were term life insurance;
- 61% of new individual life policies were some form of cash value life insurance; and
- The most common supplementary benefit is waiver of premium.

### B. Introducing Needs Analysis

A secure financial future for loved ones is built on a foundation of life insurance. Life insurance can help loved ones carry out their hopes and dreams, even after the insured is gone.

As an important part of a sound financial plan, life insurance provides a **death benefit** to beneficiaries and can replace some of the income that would have been earned. This can help preserve savings, investments, and other assets for their intended purposes.

The right amount of life insurance protection can help loved ones avoid selling their home or business or drastically altering their lifestyle to cope with financial obligations, such as funeral expenses, estate settlement costs, education costs, the mortgage, or other living expenses and other large personal or business obligations.

It is important to review the following considerations in determining the right amount and type of life insurance for your client's needs:

- Why does the person need life insurance?
- How much do they need?
- Which type of insurance is right?
- How can you choose the policy that's right?
- How much will it cost?
- How will you purchase the policy?
- When should you review coverage?

Figuring out life insurance needs requires a careful analysis periodically of what is needed, who needs to be protected, and how the financial future should look. This financial picture changes over time. It does not take a lot of time, and it's important

that you review all current assets and liabilities in order to know what is needed to help individuals maintain their financial well-being and protect their goals.

In building a plan for financial security, life insurance serves a number of purposes:

- **Creating wealth:** to protect dependents or to create inexpensive capital for charitable giving;
- **Preserving wealth:** to provide liquidity in an estate to pay estate taxes and settlement costs so other assets can be retained for heirs; or
- **Tax-deferred accumulation:** for future college education funding, collateral to start a business or take advantage of an investment opportunity, or for supplementing retirement income.

## C. Financial Planning to Analyze Need

Life insurance is an essential part of financial planning. The main reason most people buy life insurance is to replace income that would be lost with the death of a wage earner. Cash values provided by some life insurance policies also can provide an available source of funds. Accessing these funds does require that the insured **trades a reduced death benefit in exchange for the borrowing a portion of these funds**. If the **policyowner** wants to access all of the cash values accumulated, they will have to surrender the policy and will no longer be covered by a life insurance death benefit.

Life insurance proceeds could mean that dependents will not have to sell assets to pay outstanding bills or taxes. An important feature of life insurance is that, in most circumstances, income tax is not payable on death benefits. In order to set future financial goals and to accurately evaluate future needs, individuals must have a good idea of current resources. This information is derived from their income tax return, checkbook records, stock and bond records, and other financial statements.

There are three time periods for which an individual needs to plan:

- The early adult years – premature death planning;
- The middle years – pre-retirement planning; and
- The later years – estate planning.

In the early adult years, life insurance can address three categories of needs: permanent, temporary, and savings.

- **Permanent needs** for life insurance are those needs that continue until death.
- **Temporary needs** diminish over time and ultimately disappear.
- **Savings needs** include the need to provide for retirement and, in some cases, the need to keep life insurance in force after term insurance premiums would be prohibitively expensive.

In the middle years, one needs to consider the legal and financial independence of children and the repayment of all significant debt, including a home mortgage. During this time period, most individuals are approaching maximum advancement in their career. This life stage might be identified as a pre-retirement planning period. This period generally begins between the ages of 45 and 60 and ends at retirement. The problem of developing financial goals for retirement is more difficult than the problem of developing financial goals during the early adult years.

Estimating the amount needed to fund retirement is indeed complex because an individual has no idea how long he or she will live. Estimates of retirement needs made by a 50-year-old may involve expenditures planned for 20, 30, or 40 years in the future. New opportunities are arising for seniors to continue to work or to participate in educational programs instead of retiring completely.

The later years usually involve three categories of goals. These goals are

- Living objectives;
- Death **transfer** objectives; and
- Tax objectives.

## D. Objectives in Need Analysis

### 1. Living Objectives

**Living objectives** can include many concerns revolving around developing a plan to provide for the continued enjoyment of a predicted lifestyle. Such objectives may involve continuing participation in business or farming, moving to an adult community, or participating in an adult educational program.

### 2. Death Transfer Objectives

**Death transfer objectives** involve identifying the individuals or organizations that an insured wishes to receive his or her property after he or she dies. In cases where an individual has had two or more marriages – and children by each marriage – the development of death transfer objectives may prove difficult. Additionally, an individual may want to continue to fund an organization, such as a charity, after they die.

Clarity and completeness are needed in identifying all assets to be distributed. After the assets have been identified, the next step is the clear designation of the intended recipients of the assets, including the designation of beneficiaries (primary and contingent) of life insurance policies.

Death **transfer** objectives are usually formally structured in a will or living trust. Life insurance policies can play a key role in achieving death transfer objectives. First, policies can provide a lump sum of cash or a lifetime of income to designated beneficiaries. In the case of spendthrift children, or those inexperienced in money management, the insurance company's services can prove quite valuable, with the insurer guaranteeing a stream of income, rather than a lump sum, to such beneficiaries.

### 3. Tax Objectives

**Tax objectives** avoiding federal estate tax can be relatively simple if an individual's estate at death does not exceed \$5.43 million in 2015 (double this amount for a married couple).

With some simple planning steps that utilize the marital deduction and the annual gift exclusion, even larger estates can escape the imposition of this tax. On the other hand, almost all estates incur some level of probate costs, and many states impose inheritance taxes that require cash payments during estate **transfer**. Both of these problems can be addressed using life insurance.

## E. Computing Life Insurance Needs

Some experts say that one will need 6 to 8 times their annual gross income in life insurance. This is a general rule of thumb, but everyone has different needs. One should consider at least how much a family will need for funeral expenses, the mortgage, car loans, credit card debt, education for children, and retirement for a spouse if one should die prematurely.

Under this rule, if the primary breadwinner earns \$50,000 per year, he or she should have between \$300,000 and \$400,000 of life insurance. A similar rule that takes immediate cash needs into account is 5 times gross income, plus mortgage, debts, final expenses, and any other special funding needs.

Financial planning professionals apply various techniques to determine the life insurance needs of a family. There are essentially three principal areas in which to calculate need. These areas are:

1. Income replacement and family needs analysis;
2. Business insurance needs analysis; and
3. Estate preservation and liquidity needs analysis.

Any method of determining a family's insurance needs will be an estimate, since circumstances will change in unexpected ways in the future, and basic assumptions about earnings, interest rates, inflation, and similar factors are just that – assumptions. Life insurance planning is best conducted with a comprehensive study of the client's financial needs and concerns.

The process of life insurance planning must begin and end with the objectives and goals of the client being paramount, even if these objectives and goals do not conform to what the adviser considers to be proper or appropriate values or concerns.

## 1. Considering Social Security Benefits

In determining the amount and kind of insurance that is needed, an individual must consider other sources of income or benefits, such as insurance plans, government programs, and retirement plans. These other assets will help in determining the amount and type of insurance necessary to meet current and future needs.

Most workers are covered by Social Security or other government programs that provide survivor benefits to surviving spouses with dependent children and surviving spouses after age 60. This is a form of income-replacement insurance and should reduce the family support obligation accordingly.

The amount of Social Security paid to a surviving spouse with one eligible child is 150% of the deceased spouse's primary insurance amount (PIA) at the date of death. For each additional eligible child, an additional 75% of the PIA is payable. Children are eligible until age 18 – or until age 19 if the children are in high school. If disability of the children occurs before the age of 22, eligibility continues during the duration of the disability.

A surviving spouse is eligible for Social Security survivor benefits if he or she is caring for a child younger than 16 or who is disabled before age 22. Otherwise, a surviving spouse is not eligible for benefits until age 60 (or age 50-59, if he or she is disabled). This period of time between when the youngest child has reached age 16 and the surviving spouse has reached age 60 when no survivor benefits are paid is called the "blackout period."

A spouse alone is eligible for reduced benefits equal to 71.5% of the PIA starting at age 60. If the receipt of benefits is delayed, then the spouse is eligible for up to 100% of the PIA starting at age 65. A disabled spouse is eligible for 71.5% of the PIA starting at age 50. The total amount payable to the family is subject to a limit, called the **maximum family benefit**, which is generally about 175% of the PIA. Some benefits that an individual has now may not be available when he or she retires. Social Security has been a source of controversy for quite some time. There is public concern that

individuals working today will not be able to count on this system to provide them with retirement income.

When the current generation begins to retire, there may be only two workers paying in for each retired worker needing that income. To offset this trend, Social Security taxes increase and benefits decrease. Additional changes have been enforced, such as increasing the normal retirement age. The idea of do-it-yourself financial planning may be sufficient in some circumstances, but most will benefit from the advice of a personal financial adviser.

Individuals can request estimates of the amount of Social Security retirement benefit they will receive from the Social Security Administration. It is estimated that an individual will need 75% to 80% of his or her current income to maintain a lifestyle after retirement. This means that Social Security benefits will have to be supplemented by income from other sources.

In determining how much life insurance is necessary, agents should ask clients to consider the following questions:

- *In the event of death, how much money would your family need for living purposes, including paying off the mortgage and other debts?*
- *How long would this amount of income be needed? (It should last at least until the children are out of high school, and preferably until they finish college.)*
- *How much Social Security income can be expected until the children are no longer covered?*
- *What are your goals for retirement planning?*
- *What funds would be necessary for long-term nursing home care in the future?*
- *Are they taking full advantage of employer-provided qualified retirement plans, such as a 401(k)?*
- *What funds would be necessary to provide an income during periods of disability?*

## F. Consumer Application

Agent Bob is working with a couple, Bill and Sue Brown, who are both 31 years old. Both earn \$40,000 a year. They have three children: twin daughters, age 4, and a 1-year-old son. The parents are both fully insured under Social Security with identical work histories.

Agent Bob helps them determine how they want things to be handled if either of them dies. Here is what they want:

1. **Readjustment Period** – The Browns would like the surviving parent to have 5 years to adjust to life. This means they would like the surviving parent to have 100% of the current household income of \$80,000.
2. **Family Dependency Period** – The Browns realize that the surviving parent would likely have to sacrifice his or her career to ensure the children are able to continue with their many activities. They estimate that the survivor would need about 90% of current household income of \$80,000 for 21 years until their youngest child graduates from college at age 22.
3. **Pre-retirement Period** – The Browns feel that the surviving spouse would need 70% of the current income to maintain his or her lifestyle until retirement.
4. **Retirement** – At retirement age of 67, the Browns feel that the survivor can make it on 60% of the current household income (adjusted for inflation).

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## Determining the Amount of Life Insurance

### A. Defining “Need”

There are many ways to estimate an individual’s need for life insurance and we have, so far, explored a few of the more common “rule of thumb” approaches that result in broad generalizations. It is important to understand that each individual or family unit has potentially unique needs that can affect the amount of life insurance needed.

A thorough fact finding interview with the client will help the agent to better understand the current financial situation of the **applicant** as well as future needs. Like any estimating process, the more complete and accurate the input, the more comprehensive the estimate will be. Many consumers see the value of such an approach and are willing to participate by providing the information necessary to complete an accurate needs analysis.

Many insurance companies provide a computer-based needs analysis and quoting process for the agent to use in determining the **face amount** and structure of a life insurance program for a proposed insured. These programs vary in detail, but the end goal is always to help the agent and consumer quantify the need and make informed decisions.

In many situations, it may be advisable to purchase term insurance to provide the base layer of life insurance protection when the needs are the greatest and add a significantly smaller layer of cash value life insurance. This strategy will provide a much larger **face amount** of **death benefit** when the need for protection is the greatest. As the insured ages and the term renewal rates become more expensive, they can reduce the term protection and keep the lower face cash value product. Cash value policies are part insurance and part cash accumulation. Cash value premiums are higher than with a term policy for the same death benefit. In return, part of the premium accumulates tax-deferred. The money that accumulates in the policy – the cash value – allows future premiums to remain level.

Although there are rules of thumb to follow in estimating a person’s insurance need, they are very simplistic and often do not consider factors such as the family’s current net worth or the ages of the family members. Such rules of thumb normally utilize a multiple of earnings approach.

One such rule is to estimate the amount of life insurance by multiplying the wage earner’s income by a factor of 6 to 8. So, an individual earning \$100,000 annually should have \$600,000 to \$800,000 of life insurance. A similar rule takes immediate cash needs into account. The rule is 5 times gross income, plus mortgage, debts, final expenses, and other special funding needs. Assume that the same individual has a

mortgage of \$300,000, college debts of \$100,000, and he or she desires college funding requirements for his or her children, totaling \$200,000. The insurance need in this case could easily rise to \$1,100,000.

These guidelines can provide a wide range of solutions. Without looking at a family's entire financial profile, it is difficult – if not impossible – to accurately determine the proper amount of life insurance. The most reliable approach to determining the proper level of insurance is with a needs analysis. This type of analysis determines the amount of money needed to support the family and pay down outstanding liabilities, reduced by current asset holdings and future receipts of income.

The first category of need is often the most underestimated or neglected: the current cash need upon death. This category of need only exists when determining the life insurance need, since disability insurance is focused on income replacement. By including debt **liquidation** and education funding in this category, the insured leaves the family with a roof over their heads and ensures that the children will be able to attend college.

The second category is the estimated income need for the family. This amount will be different depending on whether the needs analysis is being performed for life or disability insurance. For life insurance, the income need is determined by estimating the surviving spouse's annual income requirements over his or her remaining life expectancy. This amount will typically range from two-thirds to three-quarters of the family's current income.

Once this amount is estimated, an assumption must be made regarding an **inflation percentage**. This is the amount by which the income requirement must grow each year. A second assumption must be made regarding after-tax earnings. The difference between the after-tax earnings rate and the inflation factor is the percentage that is applied to the income need in order to determine the present value of the income need. This amount represents the capital which must be set aside now to ensure that the surviving spouse receives the annual income each year for the rest of his or her life.

When calculating the income need, it is important to factor the children's income needs into the equation. Often, this need will be determined through a certain age, usually 18 or 21. This calculation must be performed for both life and disability insurance needs analyses. The income need may be reduced by an assumed amount of earnings by the spouse. However, it is common for people to disregard this amount in order to prepare for a worst-case scenario, where one spouse dies or becomes disabled and the other is unable to work.

Part of the total current cash and income needs are satisfied by the capital assets owned by the family. This will typically include cash, savings, and other liquid investment assets. Life insurance should provide sufficient death benefits to prevent the survivors having to draw down on current capital assets to meet living expenses. This does not include the value of assets that will not be sold in order to generate cash, such as the family home. The capital assets will also include the present value of any pension or other retirement benefits that will become available at some point in the future.

It is also important to factor in the present value of benefits that will be received from the Social Security Administration. Upon death, the children of the decedent may be entitled to a monthly check until they reach age 18. The surviving spouse will typically

begin to receive survivor benefits upon reaching age 60 and when they reach retirement age they will begin to receive Social Security retirement benefits. A disabled worker will begin to receive Social Security benefits upon meeting the Administration's definition of total disability.

## B. Human Life Value

A person's **human life value** depends on numerous factors, including future income levels, value of homemaking and/or child care performed by a spouse who does not generate an income, taxes, education, training, anticipated future job promotions, and various normal detrimental factors, such as the possibility of illness, disability, periods of unemployment, and the like. This approach takes into account the factors of estate clearance costs, the new amount of income or new expenses to which the family needs to adjust after the death of the breadwinner, income for the family until the children leave the home, life income for the surviving spouse, special needs of the family (such as college education for the children), and other needs. Reasonable estimates of the present value of future earnings can usually be determined using four inputs or assumptions:

1. Current annual after-tax earnings;
2. The projected rate of growth of earnings;
3. The future working lifetime; and
4. An after-tax discount rate.

Given these four factors, the present value of future earnings may be computed using the present value of an annuity formula. The formula assumes that earnings are paid annually in the middle of the year, which is a reasonable approximation to monthly or other periodic payments throughout the year.

Assuming that an individual's after-tax income is \$50,000 per year, the agent should estimate that it will grow at an average annual rate of 5%. If this individual is approximately age 35, he or she can expect to work for 30 more years. In this instance, an appropriate after-tax discount rate would be 6%.

So the present value of the future earnings is about \$1,275,000. This figure is the amount that, if invested today at a 6% after-tax rate of return, could provide an after-tax income stream payable in the middle of each year for the next 30 years, with the initial after-tax amount starting at \$50,000. Each subsequent payment will grow by 5%. After 30 years, the entire \$1,275,000 would be used.

### Example:

Let's assume that a 40-year-old insured earns \$50,000 a year and is expected to earn the same amount until he retires at age 65. Out of his annual income, \$40,000 is used to support family needs, and the remaining \$10,000 is spent on expenses specific to the insured. Obviously, the \$10,000 that is spent on expenses specific to the insured will no longer be needed if the insured dies. This means that the human life value of this insured to his family is \$1,000,000 (\$40,000 a year spent on family needs × 25 years to retirement). Based on this assumption, and taking interest and inflation into [consideration](#), the insurance company will determine the right amount of insurance to produce the same annual amount of income for the family if the insured were to die.

## C. Income Replacement Approach

The human life value concept has often been applied in wrongful death litigation and basically holds that the measure of the economic value of a life to those who depend

on that person is the present value of the future earnings potential of that person.

The income replacement approach to life insurance needs analysis is based on the premise that the basic objective of life insurance is to replace some or all of the earnings lost if an income-producing family member should die.

In other words, the insurance should be equal to the value of that person's future earnings potential to the surviving family members. The basic premise may be questionable because it ignores other equally valid reasons why a person may purchase life insurance. However, this method does allow one to estimate a maximum based on the idea that a person should never be worth more economically to beneficiaries dead than alive. This method may provide an accurate starting point for deciding how much life insurance a person needs, and is a relatively easy concept to understand.

The third approach is the **retirement needs approach**, which is often used for individuals when they are approaching retirement and have little debt or few obligations to support others. This approach calls for coordinating life insurance with other sources of retirement income, such as Social Security, pensions, and investments, to achieve a predetermined retirement income.

Most families purchase life insurance (at least initially) to protect their young, growing families. As their children grow up, they may feel that their need for insurance diminishes. The fact is, for many reasons, this need usually does not totally go away.

## 1. Family Support Ratio

Under the **income replacement approach**, insurance value is always less than human life value. The portion of after-tax income spent by the insured for self-maintenance is not available for support of the family, so only the remaining portion is devoted to or spent in support of the family. It is often assumed that about 25% of after-tax income is spent for self-maintenance and the remaining 75% for family support. However, this ratio may vary widely from family to family.

Under the basic premise of the income replacement method, one of the important elements of family support is the cost of the insurance itself. Because the amount spent for insurance is not otherwise available to support the family's standard of living, this cost should further reduce the proportion of income that is insured to support the surviving family members' standard of living. Once an estimate of the breadwinner's human life value is determined, that amount should be multiplied by the family support ratio.

The amount figured for the Family Support Ratio is not necessarily the amount of additional insurance required. This amount should be further reduced by the amount of any assets currently available to fund the survivor's income needs and by any life insurance currently in force. Among the assets that should be counted are marketable securities, savings account balances, and the like, as well as current vested account or benefit balances in employer-sponsored pension and profit-sharing plans, 403(b) tax-deferred annuities, IRAs, SEPs, and Keogh plans.

Some financial advisers feel that the family support ratio should also be increased to account for contributions or credits that would be made to employer-sponsored retirement plans, whether they are qualified or not qualified, while the breadwinner is living.

The family support ratio should be computed based on the reported after-tax income increased by the effective after-tax value of the 401(k) contributions. If the family support ratio is otherwise assumed to be 70%, it should be increased to 74.2% to account for the equivalent after-tax value of the employer-sponsored plan ( $70\% \times 6\% = 4.2\%$ ).

## D. Capital Needs Analysis

The amount of insurance should be sufficient to cover a family's economic needs if the breadwinner were to die tomorrow. Therefore, the starting point in capital needs analysis is an evaluation of income needs against the estimated income to be received upon the death of the breadwinner.

**Capital needs analysis** analyzes a client's needs and determines how life insurance can best meet those needs. From there, one can determine how much life insurance to purchase. Capital needs analysis uncovers a client's general financial problems or deficiencies so needs can be recognized. It helps ensure that the agent sells the right amount of life insurance to his or her client for the right reasons.

The average American family often finds it difficult to accumulate a meaningful amount of assets to leave to heirs. For many Americans, life insurance makes up at least 75% of the estates left behind at death.

Proponents of term insurance correctly point out that one's need for life insurance protection generally decreases over that individual's lifetime. This is because as one's obligations to others (children, mortgage company, etc.) decrease, their obligations to themselves (preparing for a stable and fulfilling retirement) increase. While this generalization is true, the need for life insurance protection rarely totally disappears.

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## The Elements of Life Insurance

### A. Life Insurance Underwriting Tables

There are many types of life insurance policies. Costs vary based on the age and health of the proposed insured, as well as the amount of coverage desired. Other provisions may influence the amount that will be available to beneficiaries. *For example*, a life [insurance policy](#) may afford greater benefits when the death is accidental. **Double indemnity insurance**, which provides such a provision for accidental death, pays twice the [face amount](#) of the policy.

All life insurance policies, regardless of whether they are term or some variation of cash value, are based on common actuary and mortality tables. The required mortality tables used are specified by the insurance regulators. That is to say that the insurance carrier is required to reserve the same amount in their legal reserves for each \$1,000 of net [death benefit](#) risk, regardless of whether the underlying policy is term or a form of cash value. So, one would think that any difference between the gross premium paid by the consumer for each \$1,000 of [face amount](#) and the amount of legal reserve deposited by the carrier for that same \$1,000 of risk could be easily reconciled.

**Net Death Benefit Risk (often called net amount at risk)** is the net death benefit paid to the beneficiary after subtracting any loan principal, loan interest, or unpaid premiums. In most variations of cash value life insurance, the cash value is returned at the death of the insured as part of the death benefit. For example, a traditional cash value policy with a face amount of \$100,000 and \$15,000 in accumulated cash values will pay a \$100,000 death benefit (assuming no policy loans or unpaid premiums). This example policy represents a net death benefit risk to the insurance company of \$85,000 (\$100,000 death benefit minus \$15,000 in cash values held by the insurance company) and the insurer will reserve for \$85,000 net death benefit risk. This is the same amount of net benefit risk that an insurance company would reserve for a term policy on the same individual with an \$85,000 face amount. There are variations of life insurance contracts based on the cash value concept that will pay the cash value in addition to the face amount of the policy. The contractual definition of death benefit is required to be explained in every life insurance contract and should be consulted for specifics.

**Actuary tables** include all charts and tables used by the [underwriter](#) to compute rates, dividends, and risks according to probabilities based on statistical records.

**Mortality tables** are charts that show the probability of death at each age and the life expectancy. *For example*, a mortality table might show that at age 34, on average 2

out of every 1,000 persons will die, but those who do not die at age 34 can expect to live about 39 more years.

## B. Financial Risk

Few people envision the extent of financial loss that will occur at death. In addition to the emotional consequences, the financial consequences of death can be devastating, especially if the deceased has financial obligations that extend to others.

Insurance is the answer to this uncertainty because it produces a substantial sum of money that becomes available precisely when needed. If all people could personally generate and accumulate enough wealth to cover financial losses, there would be no need for insurance. Because most people are not wealthy, insurance was devised as a way of having a large number of people share in the risk of financial loss.

## C. Settlements

Beneficiaries can choose to receive a life insurance **death benefit** in a number of ways, aside from the obvious and common method of a lump sum payment. There are various optional modes of settlement. A beneficiary may leave the proceeds with the insurer and receive annual interest payments, or the beneficiary may accept the proceeds in installments of a specified amount.

Beneficiaries have the following five options of settlement:

1. Interest;
2. Lump-sum;
3. Fixed-amount;
4. Fixed-period; and
5. Life annuity.

### 1. The Interest Option

The **interest option** mode of settlement is when the interest rate payable by the insurer is guaranteed and may be increased by payments of "excess" interest. This mode of settlement is also called a "*dividend*," "*extra interest*," or "*surplus interest*." The increase of the payments is done to keep the insurer competitive with alternative investments. Payment intervals such as annual, semiannual, quarterly, or monthly are agreed upon by the insurer and **beneficiary**, unless preselected by the **policyowner**.

The payee can be given the right to change to another settlement option and can either have a limited or unlimited right to take all or any portion of the principal. In some cases, the income beneficiary may be given no right to make a withdrawal of capital, in which case it will pass to the payee's estate or to a third party, depending on the terms of the agreement. At the option of the beneficiary, the principal may be paid to someone other than the interest recipient. A successor-payee should always be named to receive any amount remaining payable upon the primary payee's death.

### 2. The Lump-Sum Option

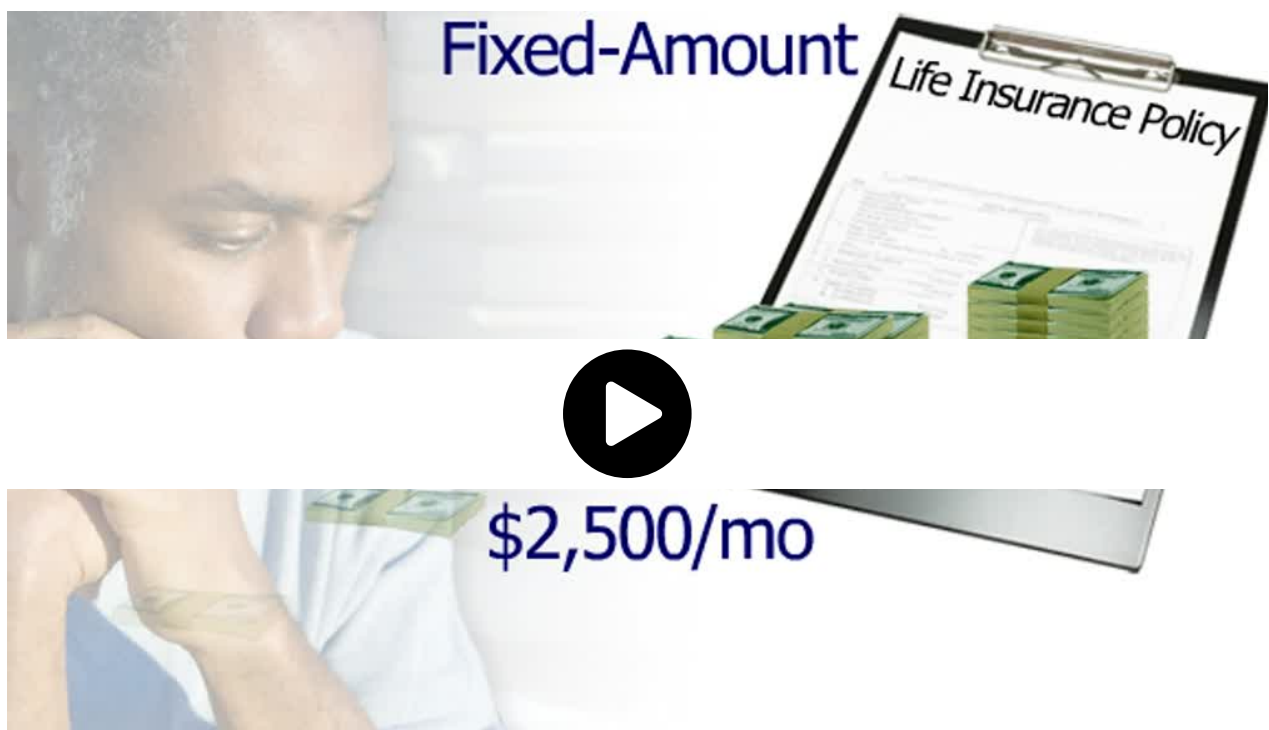
The **lump-sum option** is when the insurer makes a single lump-sum payout to the **beneficiary**. This option is the simplest for the insurer to administer. If the beneficiary is a sophisticated investor, this may be the best option. The beneficiary may be confident in his or her ability to invest and manage the lump-sum payout. The lump-sum settlement option is the default option.

If the insured fails to specify the settlement choice, this is how proceeds are paid to the beneficiary. In many cases, it is not a good idea to pay the proceeds under the lump

sum option because the beneficiary may not have the financial ability to deal with large amounts of cash, or the funds may be spent on items that are not within the wishes of the insured. Of course, selecting an option is a personal choice, but many people make the mistake of not deciding, and the beneficiary opts for immediate cash wealth.

### 3. The Fixed-Amount Option

The **fixed-amount option** means that the **policyowner** or the **beneficiary** selects a dollar amount to be paid monthly, quarterly, semiannually, or annually. Interest is credited to a diminishing **principal amount**. When funds are exhausted, payments end. In this case, the amount of death proceeds, interest credited, and periodic payment amount determine the length of time payments are made. Unpaid installments under the fixed-amount option can generally be commuted or applied under another option. This option can be used when funds are no longer required after the payout period.



### 4. The Fixed-Period Option

The **fixed-period option** makes periodic payouts with the intent to liquidate the principal over a fixed length of time, such as 20 years. Every payment is composed of principal and interest. The interest paid on the principal is guaranteed at a rate stated in the **contract**, and the insurer may choose to pay excess interest. While this option has its place, there is risk that the **beneficiary** will outlive the payments. *For example*, if a 20-year period was selected, the beneficiary who lives longer than 20 years will no longer receive income.

### 5. The Life Annuity Option

The **life annuity option** refers to a group of options that pay the **beneficiary** for a lifetime. The main advantage of having proceeds paid by an annuity is that the annuitant cannot outlive the income stream. Under the fixed-payment or fixed-period option, the beneficiary may outlive the payments. Through the insurance pooling

process, individuals who die early "give up" their principal to individuals who live longer. The amount of the payment depends on the annuitant's age and gender. Other things being equal, the older a person is when the annuity starts, the higher should be the disbursement. Because females live longer than males, females receive a lower periodic amount.

## D. Waiver of Premium

All forms of life insurance will potentially offer a waiver of premium provision or **rider**. The waiver of premium provision or rider states that if a **policyowner** is disabled for a minimum period of time (usually 45 days or longer), the insurance company will waive the premiums on the life policy as long as the policyowner remains disabled. This is a valuable option for the policyowner that can keep the life **insurance policy** in force during a period when the policyowner is not able to generate an income due to an illness or injury.

## E. Contract Law

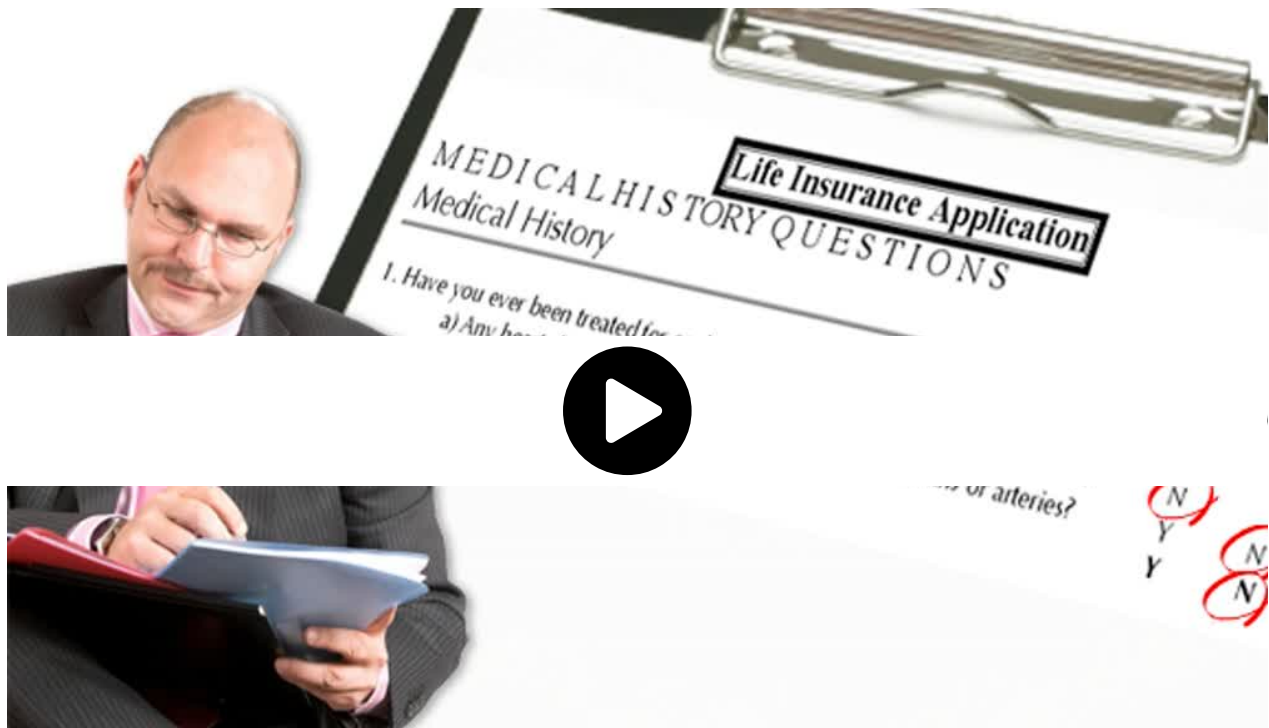
### 1. Representations and Misrepresentations

A **representation** is something that the **applicant** believes to be true to the best of his or her knowledge. A representation could turn out to be untrue, but at the time it was made, the applicant for insurance honestly believed it to be true. A statement by the insured, if construed merely as a representation, need be only "substantially correct." Before a forfeiture of the **contract** can occur because of the incorrectness of the statement, the insurer must not only prove the statement false but also show that such falsehood was of material consequence.

Untrue statements on the **application** are considered **misrepresentations** and could void the **contract**. A **material misrepresentation** is a statement that, if discovered, would alter the underwriting decision of the insurance company. A fraudulent **misrepresentation** (or contrivance) is when a person deceives someone else who is incapable of detecting the fraud, and damage could result. A misrepresentation itself is an untruth, but with the addition of **fraud**, or the intention to deceive, it becomes far more serious. If a party misrepresents himself or herself through a mistake, no blame can be attached. Agents may say something about a product to a consumer that is not true, not out of intent to mislead, but simply out of ignorance.

Agents must make sure that they are well informed about the products that they offer. If they are not sure about a given feature, they should not provide information to consumers about it until they have checked with their manager.

Although statements that an **applicant** makes are **representations**, not warranties, this does not excuse an applicant who knowingly makes false statements or misrepresentations. If an applicant makes a misrepresentation that is material to whether the insurance company issues the policy, then the insurance **contract** can be legally voided.



## 2. Warranties

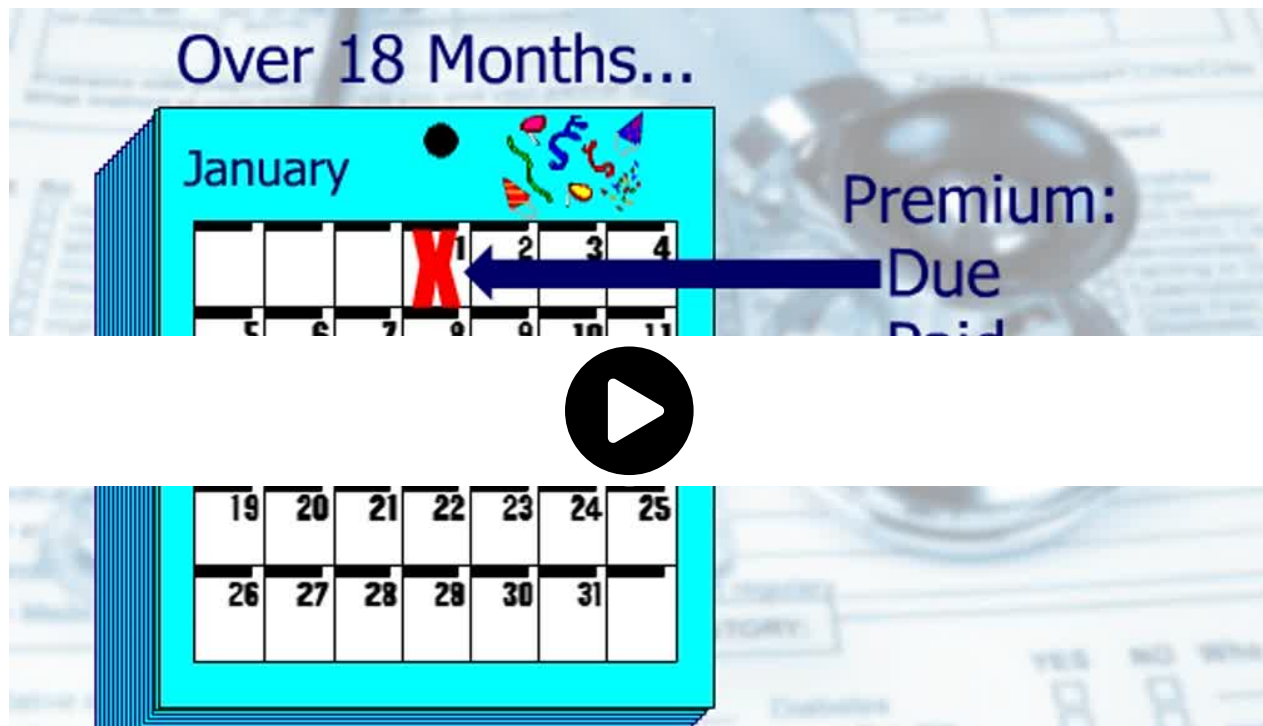
A **warranty** is a statement that must be absolutely and literally true. If it can be proven that the statement was false, regardless of how material the statement actually is, the policy provisions may be invalidated. There are two kinds of **warranties**. An **implied warranty** exists even though not expressly written into the **contract**. An **express warranty** is written into the contract by the agreement of the parties.

## 3. Waiver

In legal terms, **waiver** means voluntarily relinquishing a privilege or right. Waivers can be important in any legally enforceable **contract**. Sometimes parts of insurance policies are knowingly waived by the insurer who agrees to add an **endorsement** to the policy waiving that right. This is called an **express waiver**. A waiver occurs if the insurer knew it had the right to do or demand some action but acted with the deliberate intention of giving up that right.

## 4. Estoppel

**Estoppel**, another special element in life insurance, is a legal doctrine that prevents an entity or person from denying or changing facts that once were acknowledged as true and accepted in good faith. *For example*, a company that routinely had been accepting payments of \$1,000 per year likely would be prohibited from canceling a **contract** based upon the contract holder's failure to submit a payment of \$2,000 per year that previously was not stipulated in the contract. Estoppel is a legal consequence of a waiver.



## 5. Twisting and Churning

The term **twisting** is used to describe the practice of using misrepresentations to induce the replacement of a policy with a different carrier's policy.

The term **churning** is used to describe the practice of using **misrepresentation** to induce the replacement of a policy issued by the insurer that the agent represents. Whether **twisting** or churning, the agent's goal in such cases is to earn a new commission for himself or herself and not to serve the client's best interests.

## F. Cost Indexes

**Cost indexes** give individuals a convenient way to compare relative costs of similar policies. When comparing costs, an adjustment must take into account that money is paid and received at different times. It is not enough just to add the premiums and subtract the cash values and dividends that the individual expects to get back. Instead, the individual can just compare the published index numbers.

The **life insurance surrender cost index** is useful when considering the level of the cash values to be of primary importance. It helps to compare costs if, at some future point (such as 10 or 20 years), one were to surrender the policy and take its cash value.

The **life insurance net payment cost index** is useful if the main concern is the benefits that are to be paid at the time of death, and if the cash value is of secondary importance. It helps to compare costs at some future point if the **contract** owner continues paying premiums on the policy and does not take its cash value.

The **equivalent level annual dividend** shows the part that dividends play in determining the cost index of a participating policy. Adding a policy's equivalent level annual dividend to its cost index allows one to compare total costs of similar policies before deducting dividends.

It should also be noted that dividends are not guaranteed.

The most important thing to remember when using cost indexes is that a policy with a small index number is generally a better buy than a comparable policy with a larger index number. The following rules are also important:

- Cost comparisons should only be made between similar life insurance plans. Similar plans provide essentially the same basic benefits and require premium payments for approximately the same period of time.
- The closer policies are to being identical, the more reliable the cost comparison will be.
- Compare index numbers only for the kind of policy, the individual's age, and the amount intended to buy. Because no one company offers the lowest cost for all types of insurance at all ages and amounts of insurance, it is important that a person gets the indexes for the actual policy, age, and amount that he or she intends to buy.

Small differences in index numbers could be offset by other policy features or differences in the quality of service that one may expect from the company or its agent. Therefore, when an individual finds small differences in cost indexes, the choice should be based on something other than cost.

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## Understanding the Life Insurance Contract

### A. Introducing the Life Insurance Contract

Understanding life insurance **contract** provisions is important, since the insurance company will perform its obligations based on these provisions. The insurer is bound to performance as long as the premiums are paid when required. The contract may cease if the **policyowner** does not pay the premium or if the contract is surrendered for cash.

Some of the **contract** provisions are designed to protect the life insurance company from being defrauded by people who lie about medical problems or contemplate suicide. Many provisions, however, protect the owner, insured, and beneficiaries from the insurer acting differently than agreed to in the contract.

The policy date is used in reference to the date shown on the policy schedule from which policy years, policy months, policy anniversaries, and the premium intervals will be determined. The policy date is usually the original **effective date**. It is treated as an anniversary date and used to determine premium due dates and other important dates. The **due date** is simply the date on which all premium payments after the first payment become due. If a policy takes effect on May 8 of the current year, and that is the policy date, then May 8 will be the anniversary date for the policy.

If premiums are payable annually, then they will be due on May 8 of each year. If premiums are payable monthly, they will be due on the 8th of each month. So, the **due date** means that each premium after the first is due at the end of the period for which the preceding premium was paid. **Proceeds** are the amount payable as a **death benefit**.

If a policy has an original **face amount** of \$100,000 and dividends have been used to buy \$5,000 of additional insurance, then the proceeds (death benefit) will equal \$105,000 at that point. The **payee** is the person entitled to benefit payments under the policy. Usually, this is a designated **beneficiary**. The **owner** of the policy is the person who makes the **contract** with the insurance company. The owner has various rights and obligations, such as designating a beneficiary and making premium payments.

#### 1. Four Contract Requirements

Before a life insurance **contract** becomes effective or is said to be in force, 4 requirements must be met:

1. The contract must be for a lawful purpose.
2. The contract must have legally competent parties.
3. The contract must have involved an agreement (offer and acceptance).

4. The contract must have **consideration** (something of value that each party gives to the other).

The contract must be an exchange of value, called **consideration**.

The **offer and acceptance rule** in life insurance is that the **applicant** makes an offer, and it is up to the insurance company to accept the offer. The life insurance agent is soliciting an offer when the sales presentation is made. Only when the life insurance company accepts can there be a valid insurance **contract**. Therefore, life insurance agents cannot bind or start the life insurance contract immediately. That said, an agent may be granted the authority to issue a **conditional receipt**, which is a written acknowledgement that a completed **application** and initial premium have been received by the agent. Coverage is provided until the company issues a policy or until the application is declined. If the applicant should die before the policy is issued or declined, the company has to pay, unless there is a basis that would have allowed the company to deny coverage.

**Consideration** (money) must be exchanged before any life insurance **contract** takes effect. This exchange usually consists of paying the first premium. It does not have to be for the annual amount but can be based on a monthly or quarterly payment schedule. Because the process of offer and acceptance may take time, problems can arise in determining whether a contract existed at the time of death, even though money was sent to the insurer with the **application**.



If money is sent with the **application**, the policy normally becomes effective when the life insurance company accepts it. However, other **conditions** may be required by the company, such as delivery to a healthy insured. In the case where the premium is paid before the policy is delivered, the applicant's estate would argue that the insurer should pay the death **claim** because money had changed hands and the life insurance company would have accepted the policy.

## B. The Contract Application

Life insurance companies receive initial information about an individual through statements in the **application**. The application is usually filled out by the life insurance agent and/or the insured and allows the company to determine whether the **applicant** is insurable and, if so, to determine the premium. The types of underwriting information typically requested include the following:

- Age;
- Sex;
- Amount and type of insurance requested;
- Beneficiaries;
- Information about any other life insurance in force or applied for;
- Occupation; and
- Information about any medical **conditions** or treatment.

The second part of the **application** is usually the medical report, which commonly is completed by a physician. Life insurance also is sold on a nonmedical basis, meaning that the only medical information needed for underwriting purposes is the information supplied in the application. Applications asking for very little medical information probably will be more expensive for the individual, because the pool of insureds will be in below-average health.

## C. Parties to the Contract

A life **insurance policy** is a legally enforceable contract issued by the insurer in **consideration** of the application and the payment of premiums. There are usually 4 parties identified in life insurance contracts:

1. The insurer;
2. The insured;
3. The applicant/policyowner (if different from the insured); and
4. The **beneficiary**.

The first party, the insurer, is almost always a corporation and must be licensed in each state in which it does business. The second party is the insured, and can be any person who meets underwriting requirements. The third party is the applicant/policyowner, who often is the same individual as the insured. This individual applies for and owns the **contract** that has been made with the insurer. The applicant/policyowner can be an individual or an entity, such as a corporation, partnership, or sole proprietorship.

The fourth party is the **beneficiary**. Although beneficiaries do not sign the **application** for insurance and may not even be aware of the existence of the insurance, the beneficiary may have rights to sue the insurer after the insured's death to collect the policy proceeds, because the **contract** was intended for their benefit.

## D. Nature of Insurance Contracts

### 1. Unilateral Contracts

**Unilateral** contracts explain that the insurance company is the only party to the contract, which makes a legally enforceable promise. The policyowner's payment of premiums is technically a "condition precedent" to the insurer's liability. The insurer promises to pay a specific dollar amount if the insured dies while the policy is in force. The policyowner makes no promise to continue paying premiums.



## 2. Aleatory Contracts

**Aleatory contracts** are those in which the performance of one or both parties is contingent upon the occurrence of a particular event, and in the case of insurance may provide more in benefits than premiums paid. *For example*, after only one premium payment on a life policy a **beneficiary** may receive hundreds of thousands of dollars of death benefit; or an insurance company can collect more in premiums than it ever pays out in benefits, as in a life **insurance policy** that matures or endows at age 100 because the insured is still alive.

Aleatory contracts are of two kinds:

1. When one of the parties exposes himself or herself to lose something that will be a profit to the other, in **consideration** of a sum of money, which the latter pays for the risk. Such is the contract of insurance. In other words, the insurer takes all the risk, and the insured pays a premium to the insurer for the risk.
2. When each party runs a risk that is the consideration of the engagement of the other. *For example*, when a person buys an annuity, he or she runs the risk of losing the consideration in case of death. But the person may live and receive three times the amount of the purchase price.



### 3. Contract of Adhesion

Insurance contracts are also considered **contracts of adhesion**, meaning they are prepared by one of the parties (insurer) and accepted or rejected by the other party (insured). Insurance policies are not drawn up through negotiations, and an insured has little to say about its provisions. In other words, insurance contracts are offered on a "take-it-or-leave-it" basis by an insurer.

Since the insured does not have an opportunity to negotiate the wording in a contract of adhesion, any ambiguities in the contract are usually interpreted in favor of the insured.

### 4. Conditional Contract

As the name implies, a **conditional contract** requires that certain **conditions** be met by the **policyowner** and the company in order for the contract to be executed and before each party fulfills its obligations. *For example*, the insured must pay the premium and provide **proof of loss** in order for the insurer to cover a **claim**.

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## Understanding the Features & Benefits of Life Insurance

The features and provisions of a life **insurance policy**, to a great extent, mold the efficiency of the policy. Now we are going to look at the features of life insurance policies in general. A feature of an insurance policy is the parameters within which it operates. The features of an insurance policy have applications to the insured and the insurer, as well as to the **beneficiary**.

The insurer sets these parameters, but many times, depending on the individual that an insurance company is insuring, the parameters can be adjusted in order to put the insured and the insurer in the best position. Let's look at the features that make up the parameters of the insurance policy.

### A. The Premium

There are three primary components to an insurance projection of premiums:

1. Interest to be credited as earnings to the policy;
2. Mortality risk rate charged based on death assumptions; and
3. Insurance company operating costs and expenses of administering the policy.

Using the cost of mortality and reducing that cost to account for interest income, the insurance company has enough to pay claims. However, it does not have any money to pay operating expenses. The premium, without operating costs factored in, is the *net premium*. The insurer then adds the cost of operating the company (called loading) to the net premium. Another way to view this formula is that net premium plus loading add up to *gross premium*.

- **Mortality - Interest = Net Premium**
- **Net Premium + Expense (loading) = Gross Premium**
- **Mortality - Interest + Expense (loading) = Gross Premium**

#### Calculation Example:

Assume that

\$500 Mortality cost		\$400 Net premium
- <u>\$100 Interest</u>		+ <u>\$200 Operating cost</u>
<b>\$400 Net Premium</b>	therefore,	<b>\$600 Gross Premium</b>

Life insurance company actuaries arrive at premiums from a combination of assumptions based on probability theory, mathematical experience, operating expenses, and investment returns.

Because no two companies produce exactly the same life insurance policies, and because there are more than 2,000 companies selling life insurance policies, there are various methods that each company uses. Traditionally, life insurance premiums are quoted as annual premiums.

## 1. Net Premium

The **net premium** is not the premium that the insured pays. There is still another element that goes into premium computation. Because insurers are in business to make a profit, operating expenses must be included to arrive at the **gross premium** that the purchaser pays. Operating expenses include such things as payroll, sales commissions, overhead, taxes, and other costs of doing business. This part of the premium computation includes the loading element. So, when operating expenses are factored into the net premium figure, the result is the gross premium. This is the amount that the purchaser pays for the policy.

Life insurance premiums can be lowered if a **policyowner** shows evidence of making an effort to improve his or her health. At that point, the policyowner can ask for the insurance company to re-evaluate him or her. This may be possible if the policyowner has been involved in a dangerous sport or a hazardous occupation and that circumstance changes to a less dangerous one. This can be a reason to lower the premium rate.

## 2. Vanishing Premium

The concept of **vanishing premium** is one that has been used in selling participating whole life policies. Participating policies pay dividends, and if the dividends are allowed to accumulate over time, theoretically their accumulated and future value may be sufficient to pay all future premiums under the policy.

It is important to remember that dividends are not guaranteed, and that dividend payments may vary based on the terms of the **contract**. So although the concept of vanishing premium sounds attractive, its performance is not guaranteed.

An extension of the vanishing premium concept that was heavily marketed by some insurers was to pay the premium by borrowing against the cash values to accelerate the point at which the premium vanished. Hypothetical computer illustrations that were sometimes used to illustrate this concept did not always clearly reflect realistic interest rates for growth of cash values and dividend payments. As a result, policies sold under the vanishing premium concept did not always perform as expected.

The disappointing return on vanishing premium policies generated thousands of lawsuits against the insurers that sold them, including class-action suits against the giants in the industry. The class action suits purported to represent all of the policyholders in the country. The National Association of Insurance Commissioners (NAIC) came up with a "model law" that prohibited certain activities by insurers, their agents, or other authorized representatives. The model law prohibited the use of the terms "*vanish*," "*vanishing premium*," and other similar terms implying that a policy will become paid up dependent on nonguaranteed elements.

Policyholders still may elect to use dividends to offset their premiums, but it is important that agents communicate that dividends are not guaranteed.

## 3. Modified Premiums

Because premiums on cash value life insurance can be fairly high, some insurers allow **modified premiums**, which are lower originally – usually for the first 3 or 5 years – and

are then raised and remain level for the duration of the policy. This arrangement can be helpful for a lower-income person who wants the benefits of cash value life insurance but is currently unable to pay the higher cost.

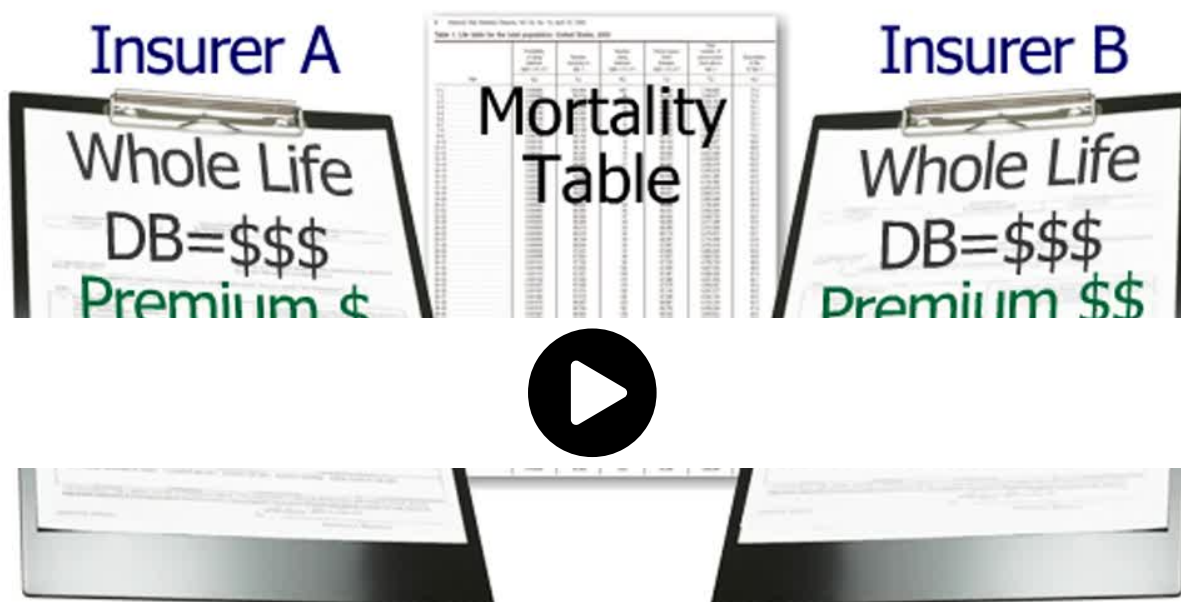
The downside is that, because the premiums are lower, cash values build more slowly. In addition, these policies typically end up costing more than similar policies without the premium modification.

#### 4. Graded Premiums

**Graded premiums** are similar to modified premiums. In this case, the premiums start out lower and gradually rise on a continuous basis, rather than jumping to a higher amount after several years. At a specified point, the premiums become level, and that level amount is paid for the duration of the policy.

The disadvantage of this arrangement is that it can take 10 or 20 years before the premiums generate any significant cash value. And like the modified premium arrangement, graded premium policies cost more in the long run than similar policies without the graded feature.

Unlike a modified whole life **insurance policy**, where the initial premium is a level amount for 3 to 5 years and is then increased to a level premium that is higher than a traditional whole life policy so that the policy will endow when the insured reaches age 100, a graded premium policy starts with a very low premium that increases annually. However, the premiums remain similar to those of an annual renewable term policy until the policy begins to create cash values (usually between 10 and 20 years). Then the premiums are necessarily extremely high in order to allow the policy to endow over a shorter period of time than a traditional whole life policy.



## B. Mortality

Mortality rates are based upon the average number of people of a specified sex and age who will die in a year's time. The rate of mortality helps life insurance companies determine how unlikely or how probable it is that a **death benefit** will be paid in the near future.

If probability is low, the insurance costs less. The higher the probability, the greater the insurance cost. There is at times an anti-selection situation that makes it very difficult for some individuals to get life insurance coverage. This situation can happen with older people because they have a wider variety of abnormal blood or medical examination findings. The seniors are evaluated by the same standards as 35-year-olds.

When there are specifics for the senior market, then they are put in a mortality pool of their own, where experience is shared. Although this is fairly simplistic, it broadly describes how mortality rates affect insurance premiums.

**Mortality tables** indicate the number of individuals within a specified group (e.g. males/females, smokers/nonsmokers) starting at a certain age who are expected to be alive at a succeeding age. These tables indicate to a life insurance company the natural premium for an individual applying for life insurance. *Natural premium* is the amount of premium that must be collected from each member of a group composed of the same age, sex, and risk in order to pay \$1,000 for each death that will occur in the group each year.

## C. Payment Frequency

**Payment modes** are methods an insured may choose for payment of premiums. Sometimes single premium policies are available. However, more often an insured will choose to pay in one of these modes:

- Annually (once every 12 months);
- Semiannually (twice every 12 months);
- Quarterly (once every 3 months); or
- Monthly (once every month).

The gross premiums computed based on elements already discussed are annual premiums. If the **policyowner** wants to make smaller but more frequent payments, the insurance company incurs slightly higher processing expenses. As a result, a small additional charge is added when the mode is more frequent than annually.

Therefore, determining the premium to be paid semiannually is not simply a matter of dividing the annual premium by two because the insurer will calculate another small charge to be added for expenses. After the original payment mode has been established, a policyowner might request permission to make premium payments either more or less frequently. In some cases, the insurance company might require this change to be requested and approved in writing; in others, the change can be handled over the telephone.

### 1. Single Premium Whole Life Insurance

Although fixed, level premium payments represent the most common method for purchasing insurance, single premium whole life insurance policies are also available. In this case, the insured buys the policy with just one large lump-sum premium, and the policy is paid-up for life, providing both insurance protection and immediate cash value. Because a large cash value is available from the onset of the policy, the interest earnings over the years are likely to be greater. And while a single premium policy

requires a greater cash outlay initially, it actually costs less in the long run because it is not subject to the ongoing administrative charges that the insurance company incurs each time a premium payment is made.

## 2. Single Premium Ordinary Whole Life

A single premium ordinary whole life [insurance policy](#) usually will show a schedule of projected dividends. The dividend schedule is not guaranteed. If the company's investment and mortality experience is favorable, dividends paid on the policy may be higher than projected; if experience is unfavorable, dividends may fall below projections.

Because all newly purchased single premium policies are likely to be modified endowment contracts (MECs), if dividends are paid to the [policyowner](#) in cash or retained by the insurer to pay principal or interest on a policy loan, they are treated as payments received under a contract and may be subject to income tax.

Although some [stock companies](#) have offered nonparticipating single premium policies in the past, these policies are virtually nonexistent today, having been replaced in most instances by single premium current-assumption whole life insurance policies, which will be discussed later.

When participating ordinary whole life insurance is configured as a single payment policy, the [policyowner](#) is guaranteed that the face value of the policy will never decline. The policyowner also is guaranteed that no further premiums will be required to keep the policy in force. The third guarantee is that the cash values will grow exactly as shown in the schedule in the [contract](#). The cash value schedule is based on a guaranteed minimum rate of interest of between 4% and 6%.

Dividends paid on participating single premium ordinary whole life insurance policies are typically used to buy "paid-up additions," which are essentially just small additional single premium policies. In general, the [policyowner](#) can expect the total [face amount](#) of coverage to increase over time.



### 3. Single Premium Current-Assumption Whole Life

Similar to ordinary whole life policies, current-assumption whole life insurance policies usually guarantee that mortality charges will not exceed certain maximums. However, the interest rate credited to cash values usually is quoted net of mortality and other expenses. In other words, in contrast with universal life policies, the policy illustrations make no explicit recognition of mortality charges. Because mortality charges are not broken out and separately stated, it is difficult to tell whether any reductions in the interest rate credited to cash values are attributable to poor investment performance or excess mortality.

Most single premium policies are single premium current-assumption whole life insurance policies. These policies are also called "interest-sensitive whole life." The interest-sensitive identification is understandable, however, because these policies are marketed by focusing on the interest rate that is credited to cash values. They generally guarantee a very competitive rate for at least one year after the policy issue date and sometimes for up to 10 years.

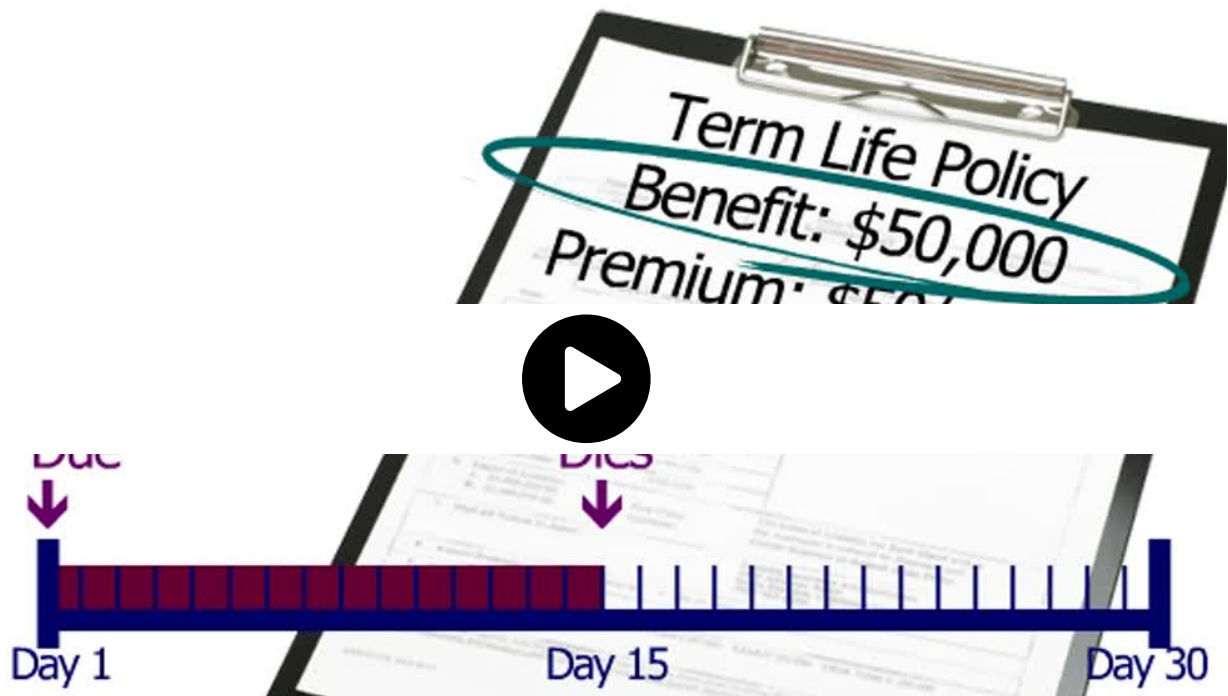
As pointed out earlier, the interest credited is shown net of mortality and other expenses (which are not disclosed), so without knowing the amount of mortality and other expenses, solving for the actual interest rate credited is not possible for the consumer.

Current-assumption whole life insurance is a type of policy in which the company's favorable investment and mortality experience is reflected directly in the interest rate credited to cash values.



## D. Grace Period

This feature of a life [insurance policy](#) is given to protect the insured against an inadvertent [lapse](#) in the policy. The **grace period** is an extended period of time (31 days in most states) in which the policy remains in full force despite the fact that the premium has not been paid. This feature is to protect the beneficiaries if the [policyowner](#) happens to die during the late payment period, because the [death benefit](#) remains payable. However, any premium due to cover the grace period extension would be deducted from the final settlement. Without this feature, if a payment was even one day late, benefits could be denied. Also, the policyowner might have to furnish evidence of [insurability](#) to continue coverage at a later date. If the premium is not paid during the grace period, the policy terminates or lapses, and no further insurance protection exists. In some cases, the policy could be continued under one of the nonforfeiture options.



## E. Ownership Rights

The owner of a life **insurance policy** is entitled to certain rights. These include the right to assign or **transfer** the policy, as well as the right to select/change the payment schedule, **beneficiary**, and settlement option or cancel the policy. The owner also has the right to receive cash values and dividends, and the right to borrow from the cash values.

The owner and the policyholder may be two different parties. This is something to consider when assigning ownership of the policy to someone other than the policyholder. Assigning a life insurance policy to another person is the right of the owner of the policy. There are two types of assignment: collateral assignment and absolute assignment.

Life insurance death benefits are generally received by the **beneficiary** free of federal income tax, but the proceeds are included in the gross estate for federal estate tax purposes. If an individual does not own the policy on his or her life, then the proceeds would not be included in the estate, thereby potentially reducing the federal estate tax liability.

The **policyowner** may also have considered selling a life **insurance policy** in return for an immediate, reduced cash amount. Viatical settlement companies emerged in the 1980s and are in the business of purchasing the life insurance policies of terminally ill insureds. They will offer an amount less than the **face amount** and after purchasing the policy, the viatical settlement company will be the new owner and beneficiary.

Although it might be tempting for a terminally ill insured in need of money to sell a life policy to a viatical settlement company, the insured should first determine if the life **insurance policy** offers an accelerated benefit. Accelerated benefits allow terminally ill individuals to receive part of their **death benefit** before they die. The amount of the accelerated benefit plus interest and administrative fees is subtracted from the

remaining death benefit paid when the insured dies. Some companies allow an accelerated benefit of up to 90% of the **face amount** and all policy forms, including term insurance, typically offer this benefit.

Policyowners may restrict their rights under a life insurance policy by naming an irrevocable beneficiary (a beneficiary that cannot be changed). Not only does the designation of an irrevocable beneficiary require that policyowners obtain written consent to change the beneficiary, they must also consent to any policy loan that would impair the benefits payable to the beneficiary if the loan were not repaid.

## 1. Third-party Ownership

Most insurance policies are written where the insured and owner of the policy are the same person. However, there are situations in which the **contract** may be owned by someone other than the insured. These types of contracts are known as third-party ownership. Most policies involving **third-party ownership** are written in business situations or for minors in which the parent owns the policy. *Third-party owner* is a legal term used to identify an individual or entity that is not an insured under the contract, but that has a legally enforceable right under it.

## F. Cash Value

A cash value policy may very well involve a substantial front-end charge or load that will appear as a reduction or, in some instances, as an elimination of cash value in the first years of the policy. However, as the cash value policy matures, the **policyowner** will have the advantage of having cash at his or her disposal to finance a new home or a college education.

The cash value build-up in a life **insurance policy** supports various other features. These features could be loan provisions and nonforfeiture options. The insurance industry as a whole strongly promotes cash value life insurance, including traditional whole life, universal life, and variable life insurance.

In the later years of the cash value policy, the owner can pay a much-reduced premium, even to the point of discontinuing the payments for a period and letting the cash value build-up pay the premiums. In many traditional cash value life insurance contracts, the schedule of guaranteed minimum cash values is predetermined when the policy is purchased.

In the newer cash value policies, the cash value is not predetermined but is primarily a function of the size of premium payments – over which the insured exercises considerable control – and also the future investment's returns. The cash value of these newer products is determined by a formula approach, in which the amount of cash value is a function of four factors.

In the first couple of years in a policy, the cash value is equal to zero because the insurance company deducts certain expenses, including the agent's sales commission. Over the life of the policy, however, there is a steady increase in the amount of the cash until age 100, at which point the cash value is exactly equal to the policy's **face amount**. If a **policyowner** is fortunate enough to live to age 100 and own a \$200,000 whole life policy, he or she will get a \$200,000 check as a birthday present from the insurance company. Whole life policies do not need to be held until death or age 100 in order for benefits to be available.

In most forms of cash value insurance, the cash value is guaranteed, which means that if the policyowner cancels or surrenders the policy after paying premiums for a

number of years, he or she will receive the cash value less any surrender charges, if applicable. If the policyowner does keep the policy in effect by paying premiums, the individual may access the cash value by borrowing it in the form of a policy loan.

## Chapter Complete

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## Life Policy Features and Benefits - Policy Loans

### A. Overview

After a cash value policy has been in force for a specified period of time (usually 3 years), it must contain cash value that the **policyowner** is entitled to borrow. He or she may use this as money in a savings account, and the policyowner can choose not to repay the loan. It is important to note that if the insured dies with a policy loan outstanding, the amount of the outstanding loan plus any accrued interest will be deducted from the **death benefit** paid to the beneficiary.

The policyowner is responsible for paying the interest on the loan at the rate stated in the **contract**, typically 6% to 8%. The interest rate is stated in the contract. It may seem strange for the policyowner to pay interest on his or her money that is being lent. The cash value accumulation the insurance company has guaranteed to the policyowner depends on the interest that the money has earned while being held by the insurer.

If the **policyowner** has withdrawn cash value, the insurance company can only meet its obligation to this policyowner by charging interest. On all loans, the interest is deducted from the amount of the loan. If the premium was paid with after-tax dollars and the loan is repayable, there is never a tax. The only time there might be a tax is if the policy is surrendered and the cash value is greater than the premiums paid.

The insurer has the right to defer a loan request for up to 6 months, unless the reason for the loan is to pay premiums due. The loan value that is available to the policyowner is the largest amount which, with accrued interest, does not exceed the cash value either on the next premium due date or at the end of one year from the date of the loan.

A common practice is to charge interest at the end of the year. The exception is when the policyowner borrows the entire amount of the cash value. In that case, the interest charge is deducted from the proceeds of the loan paid to the policyowner.

### 1. Collateral

The cash value of a life **insurance policy** serves as the collateral for a policy loan in the same way that a house serves as collateral for a mortgage loan. Therefore, in order to borrow \$1,000, there must be at least that much cash value in the policy. Actually, there must be slightly more due to interest.

### 2. Interest

The low interest rate traditionally charged for policy loans is one reason such loans are attractive, with a 4% to 6% fixed rate being common in the past. Rate information is stated in the policy. Variable interest rates that are tied to a financial benchmark such as the U.S. Treasury bill rate or Moody's long-term bond rate also are common.

When a variable rate applies, the policy specifies when the insurer will adjust the rate, such as on the first day of each calendar quarter. Interest accrues on a daily basis from the date of the loan on policy loans and from the premium due date on premium loans, and is compounded annually. Interest unpaid on a loan anniversary is added to and becomes part of the loan principal and bears interest on the same terms.

For universal and variable life policies, insurers might pay a lower interest rate on the borrowed portion of cash value that is serving as collateral for a loan. That is, the typically higher current interest rate is paid on cash values that are not collateral, and a lower rate (often the guaranteed rate) is paid on the portion borrowed.

Additionally, universal life policy loans might be **wash loans**, with the interest charged on the loan canceling out the interest paid on the cash value that serves as collateral. Policies other than universal and variable life also have arrangements for paying a lower rate on loaned cash values.

Some companies, for example, pay 1% less on the loaned values than on the remainder of the cash value.

### 3. Direct Recognition

Under a principle called **direct recognition**, a policy loan can have a significant negative impact on dividends paid under participating policies. When determining the dividend to be paid on a particular policy, companies that use direct recognition take into account the interest rate that the insurer earns on the loan and the dividend interest rate that the company has assumed it would have earned on the cash value if part of it had not been borrowed. The difference reduces the dividend.

*For example, a **policyowner** has an outstanding policy loan of \$5,000, for which he is paying 7% interest. The insurer declares a dividend interest rate of 10%. The dividend that is due to be paid is \$500.*

Because the \$5,000 loaned to the policyowner is not available to earn the assumed rate, the insurer earns only the 7% interest paid by the borrower: 3% less than assumed. 3% of \$5,000 is \$150, so this \$150 is subtracted from the dividend paid. Instead of receiving the full \$500 dividend, this policyowner receives only \$350 because of the outstanding loan.

### 4. Loan Repayment

Because borrowing cash values represents a loan, repayment is expected. Practically speaking, though, the loan never needs to be repaid. The **policyowner** may continue paying interest on the loan indefinitely. The negative consequences for not repaying loans from cash values can include the following:

- Reduction of the **death benefit** of the amount of the loan;
- Reduction of the **surrender value** if the policyowner wants to terminate the policy and take the entire cash value;
- Effect of dividend payments in participating policies;
- Reduction of interest earned; and
- Potential depletion of values, causing **lapse** of universal or variable policies.

### 5. Automatic Premium Loan

Although not part of the policy's nonforfeiture values or options, the **automatic premium loan** (APL) option or feature is related to the policy's available cash value. If an insured fails to pay the premium on time and the policy lapses beyond the 31-day **grace period**, the automatic loan provision kicks in and pays the premium by deducting the unpaid premium from the cash value. This is considered a loan against the cash values of the policy.

The only requirement is that enough cash must remain in the cash value portion of the policy to cover the loan. This provision is not automatically included in every cash value life insurance **contract**. Typically, the insured must request the automatic premium loan provision in the insurance **application**. Most policies except term and universal (in which mortality is paid from the cash value) offer the automatic premium loan provision, provided there is sufficient cash value.

The insurer expects to be repaid, and the **policyowner** pays interest on the amount of the outstanding loan. If the loan is not repaid before the insured dies, the loaned amount plus any accrued interest will be deducted from the **death benefit**. There is no charge for this option, because the premium is being paid by the policy's cash value.

Any special coverage riders remain in force as a result of an automatic premium loan. Also, if the policy is a participating policy, dividends will continue to be paid.

## B. Death Benefit Feature

In December 1988, the Washington Insurance Commissioner adopted a rule establishing a minimum ratio between death benefits and premiums that had to be maintained by life insurers in order to ensure that death benefits payable under a life **insurance policy** were reasonable in relation to premiums paid for the insurance. In general, during its first 10 years, life insurance covered by the rule had to provide benefits that equaled or exceeded the premiums paid so far, plus interest. The rule did not apply to policies that had a minimum death benefit of \$25,000 or more.

A number of representatives from various insurance companies testified at public hearings and argued that the rule exceeded the Commissioner's statutory grant of authority. The Commissioner's response explained that the intent of the rule was to deal with small life insurance policies issued to older buyers, where high mortality rates and heavy expense loading could result in unfair results.

Many of the policies that were targeted had a very small timeframe in which the premiums paid would exceed the benefits available. Even if the **policyowner** died within a small window of time, the premiums paid would exceed the benefits available, or the **death benefit** would be so small as to be virtually meaningless.

Although the life insurance **contract** is between the policyowner and the insurer, once that person has died, a contractual arrangement exists between the insurer and the beneficiary. The beneficiary may even sue the insurer if payment is not received upon proper proof of death. One of the unique features of life insurance is that the insurance proceeds or the death benefits are exempt from the claims of the policyowner's creditors as long as there is a named beneficiary other than the policyowner's estate. Even the cash value of a life **insurance policy** is generally protected from creditors.

The **spendthrift clause** is designed to protect the **beneficiary** from losing life insurance proceeds to creditors, assigning the proceeds to others, or spending large sums recklessly. The spendthrift clause is not applicable to lump-sum settlements but is

operative with [settlement options](#). It only protects the portion of proceeds not yet paid from the claims of creditors, to the extent permitted by law. As long as the proceeds are paid according to a settlement option in which the insurer keeps the proceeds and sends a monthly payment to the beneficiary, then the amounts received by a beneficiary are exempt from the claims of the beneficiary's creditors.

The **facility of payment clause** is contained in most industrial, group, and fraternal life insurance policies. It is designed to simplify benefit payments when there is doubt regarding the identity of the policy's [beneficiary](#). When any relative or person has physical possession of the policy and appears equitably entitled to its benefits, most states have statutes that define who and how much may be paid under the clause. Often the funeral home that provided the burial of the insured is paid first.

## C. Policy Loan Provision

One of the secondary benefits of a permanent life [insurance policy](#) is the **policy loan provision**. This provision allows an insured, at any time when there is cash value accumulation, to obtain a loan from the insurance company and use the policy as collateral.

This sometimes creates problems for the insurance company, because life insurance rates explicitly are considered the investment income that will be earned on prepaid premiums. The lower earnings realized on policy loans create a subsidy from nonborrowers to borrowers.

In the 1970s and 1980s (when interest rates were very high), insurers and other financial institutions experienced disintermediation as policyowners took cash value out of their life insurance policies to invest elsewhere at higher rates. In an effort to address this problem, the NAIC adopted a "model policy loan interest rate law" which permits variable rate policy loans. Some variation of this model law has been enacted by every state.

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## Term Life Insurance

There are many types of life insurance products available for consumers. Although all life insurance products offer death protection, each type also includes unique features and benefits and is designed to serve different insureds' needs. Life insurance basically comes in two forms. Term insurance pays only a **death benefit** (a specified sum of money to the person or entity designated in the policy) if death occurs within a specified period of time. This is an immediate benefit on the occasion of death and for a certain amount of years after death. Permanent insurance comes with an additional feature that builds tax-deferred savings called cash value.

### A. Term Life Policies – Overview

Let's look at term policies: Term life insurance is often called **temporary protection** because coverage lasts only for a specified period of time (the term of the policy). It should be noted that a consumer can buy a term life **insurance policy** that will commit to insure the **policyowner** for their entire life and guarantee the rates (which do increase with age) in advance. Term life insurance is available for set periods of time (such as 3, 5, 10, 15, 25, 30, or even 40 years) during which the premiums are guaranteed not to increase. If the insured dies during the specified timeframe, the policy pays the **death benefit** to the beneficiaries. Unless the policy is renewed or converted before the end of the term, the coverage expires.

It's important to note that most term policies provide for **guaranteed renewability** (no proof of **insurability** required) at the end of each term with future rates guaranteed in advance. Because a term life insurance policy provides only the element of protection with no cash values, it is often referred to as pure death protection. *What does that mean to the beneficiary and the policyowner?*

- If the insured dies during this term, the policy pays the death benefit to the beneficiary.
- If the policy is canceled or expires prior to the insured's death, nothing is payable at the end of the term.
- There is no cash value in the policy.

The advantage of term policies is that they provide the greatest amount of coverage for the lowest premium.

### 1. Types of Term Policies

Let's look at the three different types of term policies available. Keep in mind that regardless of the type of **death benefit** offered, the premium is level – or remains the same throughout the term of the policy.

First is **level term**. The majority of term life insurance policies in force today are level premium policies. The insurer averages the premiums for the length of the term and overcharges in the earlier years (this is called front-loading), and effectively undercharges in later years. This allows the premium to remain the same throughout the life of the policy without putting the insurer at increased risk. When a term policy is categorized as level, that refers to the **face amount** and premium which both remain the same throughout the **policy period**, unless a cost of living increase automatically increases the face amount during the policy term. Level term policies are available in various term lengths from 3 years to 40 years. With the exception of providing cash values and any benefits related to cash values, such as loans, term policies can and do generally offer all of the options, benefits, and riders available in cash value policies.

**Annual renewable term (ART)** is the purest form of term coverage. While technically it is a level premium policy, since the term of the policy is only one year, premiums increase every year. The term of the policy is one year, and it is guaranteed to be renewed each year without proof of **insurability** and future rates are guaranteed in advance. The death benefit remains the same, but the premium increases each year as the insured ages and the probability of death increases. ART is a great choice to cover an obligation that is expected to expire within a relatively short period. For example; a business owner has a debt that, according to the loan payment schedule, will be paid off in the next 7 years, but the business owner anticipates that they will be able to pay the debt off sooner. It may be cheaper to buy ART to cover this loan than any other form of insurance.

The second type of term policy is an **increasing term**. Increasing term policies have a level premium, but the **face amount** increases every year of the policy term. The increase is generally a specific amount per year, or a percentage of the original amount. Increasing term policies often are used to fund riders that provide a refund of premium upon death or gradual increases in total coverage, like a "cost of living increase" riders. Often the increasing term insurance product is a rider within another policy that is used to implement a cost of living rider in the main policy.

Finally, there is a **decreasing term** policy.

As you would expect, decreasing term policies feature a level premium, and a **death benefit** that decreases each year of the policy. So why would somebody want to buy a policy that has that feature? The most common use for decreasing term is when the need for protection decreases over time. A good **application** of decreasing term is to cover the outstanding balance of a mortgage if the insured dies prematurely. The amount of coverage decreases each year, but so does the loan balance or debt. When the policy ends, it has fulfilled its purpose. Another application of decreasing term is to account for a projected general decrease in need for life insurance. Since many mortgages are 30 years in length, decreasing term is available in terms of up to 30 years and can be used to approximate a predicted decrease in overall need for life insurance protection.

A decreasing term policy often is convertible, and because there is no death benefit at the end of the term, it is generally not renewable.

## B. Nonrenewable Term Life Insurance

Nonrenewable term life provides coverage only for a short time (usually a year) and is pure death-benefit protection. The risk with nonrenewable term life is that your health might deteriorate and you could be unable to get another policy once the term is up.

Premiums also increase as you age. The overwhelming majority of term insurance is guaranteed renewable, which allows the insured to renew their coverage without proof of [insurability](#) into another term of coverage with rates guaranteed in advance.

### C. Annual Renewable and Convertible Term

Annual renewable term insurance offers coverage for an extended period, usually 5, 10, or 20 years. The premium increases each year of the [contract](#) and premiums for the duration of the coverage are guaranteed in advance.

Convertible term offers the option to convert to a form of cash value insurance in the future when regular term premiums might become prohibitively expensive.

Convertible term policies usually provide the maximum protection with the smallest amount of cash outlay required. This is sometimes chosen by young people who are unable to afford the higher cost of cash value insurance, need maximum life insurance coverage and want the option of converting to cash value insurance in the future.

### D. Selecting a Suitable Solution: Term vs. Permanent

*Which product do you recommend to your client?* Your client is looking to you for some direction here. If you knew exactly when the client was going to die, it would be easy to tell him or her which product is best (at least from the insurance standpoint).

Term insurance offers maximum protection with a smaller outlay, but as a person gets older the premiums increase. Some planners argue that people can do better with their money in a side investment that will eventually be large enough to offset the steadily increasing term insurance premiums. While from a mathematical perspective, this is true, it is important that the insured is committed to making regular contributions into an investment account. If the [policyowner](#) has not maximized the available qualified retirement plans available to them, such as an IRA or 401(k), they may find it easier to accumulate funds in a tax [deductible](#) retirement account than in a cash value policy.

Permanent policy cash values accumulate on a tax-deferred basis, whereas most investment earnings are taxed each year as they grow. There is also the chance that the investments won't grow as expected.

Check your company's rates and compare the premiums for a permanent policy with that of a term policy for the same [face amount](#) of coverage at age 30. Then look at the price for the same policies at age 60. See how the cost of the term insurance over that time compares with the cost of the permanent insurance, and look at the cash value of the permanent insurance at that age. Which would you rather have been paying for?

The main reason for purchasing life insurance is to provide a [death benefit](#) when it is needed. It may be a matter of using term insurance for temporary needs and permanent insurance for long-term needs. Consider your clients' budget, and be prepared to monitor the plan periodically so you can recommend changes when necessary.

### E. Consumer Application

Two young, recently married professionals just purchased and furnished their new home. Their salaries allowed them to qualify for a \$350,000 mortgage. At work, each has a generous 401(k) plan, but now they want to maximize the matching contributions. They each have a car loan and over \$25,000 in educational loans on

which they are making payments. They have no children at this time, but hope to start a family in the next 5 years.

Given the size of their debts, income, mortgage, and tax-favored savings plans at work, term insurance is the most cost-effective life insurance option for these insured.

## F. Suitability

### 1. Appropriate Sales

Term life insurance is primarily suited for investors with short-term life insurance needs (such as 20 years or less) or those with a long-term need but whose budget won't allow for higher premiums.

If the client's major goal is to provide a **death benefit** for heirs, and he or she does not anticipate needing access to policy cash values in less than 20 years, then term insurance may be the best option when combined with other noninsurance investments, because permanent life insurance cash values take a significant amount of time to accumulate.

Even if the client anticipates not needing access to cash values for 20 years or more, if the client is not subject to high income taxes, term insurance may still be the best protection option when combined with other investments because many other investments have lower costs and fees than cash value insurance.

### 2. Suitability Checklist

*What are your primary objectives in obtaining life insurance coverage?*

- \_\_\_\_\_ Asset preservation
- \_\_\_\_\_ Debt protection
- \_\_\_\_\_ Death benefit for heirs (liquidity for taxes)
- \_\_\_\_\_ Funeral expenses
- \_\_\_\_\_ Income replacement (major wage earner)
- \_\_\_\_\_ Business continuity
- \_\_\_\_\_ Charitable gifting
- \_\_\_\_\_ Retirement supplement

*Which of the following statements best summarize your financial objectives?*

- \_\_\_\_\_ My goal is to pay a low premium and have **death benefit** protection for a limited time.
- \_\_\_\_\_ I want death benefit protection and access to cash values for life.
- \_\_\_\_\_ I want to be able to access cash values in the future.
- \_\_\_\_\_ I want death benefit and premium guarantees.
- \_\_\_\_\_ I plan to keep this policy in force for at least 15 years.
- \_\_\_\_\_ I am concerned about inflation and want to take steps to reduce its impact on my future finances.
- \_\_\_\_\_ It is important for me to be able to change the underlying investments in my policy.
- \_\_\_\_\_ It is important for me to be able to increase or decrease the policy death benefit.
- \_\_\_\_\_ It is important for me to have some flexibility in premium payment amounts.
- \_\_\_\_\_ I am comfortable with some risk to principal because it offers the best potential for long-term results.

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## Whole Life Insurance

Now, we will turn our attention to cash value policies. We will review the main features of cash value insurance and basic types of policies available to consumers.

The first thing to remember is that cash value insurance combines life insurance coverage with a cash accumulation feature.

### A. Introducing Whole Life Insurance

Prior to 1975, almost all cash value life insurance policies issued by companies in the U.S. had the investment portion of premiums invested in the general portfolio of the company. The long-term general account portfolio of life insurance companies is comprised primarily of bonds and mortgages. The fixed interest rate bonds and mortgages within the insurance company's general account investment portfolio earn the prevailing interest rate at the time they are purchased. Until 1975, whole life insurance policies whose investment element was in the general account of the insurance company were the dominant investment type of policy available in the U.S. The policy may have been called a family policy, life paid-up at 65 policy, endowment policy, 10- or 20-pay life policy, or even a single-pay life policy.

**Whole life** insurance provides a [death benefit](#) and an accumulating cash value. By definition, it has a fixed premium and a level death benefit to age 100. The premiums do not increase with age, which averages the cost of the policy over a person's life. The cash value increases with time until it equals the death benefit at age 100. Whole life also is known as ordinary (or permanent) life insurance. This type of policy never has to be renewed or converted.

The most common variations of whole life are modified premium and graded premium. These policies are used when whole life protection is desired but cannot be afforded. Modified premium policies typically have a lower fixed premium for the first 3- or 5-year period, at which point premiums increase. Graded premium policies are similar, except the premium increases each year for the first 5 years and then becomes fixed after that. Modified and graded premium policies work well for individuals who expect to experience an increase in their income in the near future. Another common version of whole life is limited-pay.

A whole life policy requires the lowest premium out of all cash value policies because premiums are payable over the entire life of the insured up to and including age 100. At that age, the cash value is exactly equal to the [face amount](#) of the policy, and that amount is paid to the [policyowner](#). In other words, the policy endows. Whole life insurance also always involves a savings feature called a cash surrender value.

## B. Whole Life Insurance, Premiums, and Cash Values

When an individual purchases a traditional whole life policy, a fixed premium is paid for life or as long as the policy is kept in force. In exchange for this premium, the insurance company promises to pay a set benefit upon the death of the **policyowner** at any age under 100. On the other hand, the insurance company agrees to pay the insured the **face amount** of the policy if the policyowner reaches age 100 or pay the **beneficiary** the face amount if the insured dies prior to reaching age 100. So, the policy remains in force until the policyowner either dies or reaches age 100, as long as scheduled premiums are paid.

Generally, the premiums for this type of policy remain the same throughout the life of the insured. During the early years of the policy, premiums are considerably higher than those of term insurance policies. The younger the insured is at the time of policy issue, the greater this disparity in premiums is.

Each whole life **insurance policy** premium may be paid throughout the insured's entire life or for a portion of his or her life (e.g., 10, 20, or 30 years). The premiums are substantially higher for whole life insurance than for term insurance. The reason for this is that the policy has investment features and the premiums are being averaged over a longer period of time.

In a **single premium whole life policy**, premiums are paid in one lump sum when the policy is taken out. In a straight life policy, the insured pays premiums for life. Limited life policies, like 10-pay or 20-pay life, are available in which premiums are paid over a specified period of time. Each of these variants of whole life insurance will be discussed in detail later.

Whole life policies build cash values. Basic cash values are guaranteed, and the growth in cash values is tax-deferred under current federal income tax law. Participating whole life policies are also eligible for dividends. While cash values are guaranteed by the company, dividends are not guaranteed because they depend on the actual results of the company's operations.

Whole life insurance is well-suited to needs that do not diminish over time, such as paying estate settlement costs and taxes. Cash value accumulates on a tax-deferred basis and at a rate based upon numerous factors, including the investment experience of the insurance company.

## C. Features and Benefits of Whole Life Insurance

Whole life insurance contains various features and benefits. Some of these features are guaranteed mortality charges, with the premium and **death benefit** guaranteed as well. Depending on whether the policy is purchased from a mutual company or a stock company, a **policyowner** may be eligible to receive an annual refund of part of the premium paid in the form of a dividend, which is determined each year by the company.

**Guaranteed death benefits.** Whole life insurance, like all forms of life insurance, provides immediate cash in the form of a death benefit. These death benefits are guaranteed, so the family can depend on them to pay debts and other obligations or to settle an estate. The guaranteed death benefits will help to replace the lost income after the death of the **policyowner**, and they can also help **transfer** a business.

**Premium plans.** Whole life insurance offers many different premium payment options. The continuous, level premium plan requires the insured to pay a constant amount

until death or age 100. Because level premium life insurance involves premium payments in later years, presumably after employment has ended, other plans are available to limit the number of payments or to accept payments only until a specified age is reached. A whole life policy has a fixed premium, minimum guaranteed interest rate, and maximum guaranteed cost of insurance. The insurance company may pay a dividend or excess interest each year. These payments are based on the difference between actual and guaranteed experience in mortality, investments, and expenses. Dividends are not guaranteed but are generally expected to be paid at a rate higher than the guarantees.

The difference in premium payments between level premium and whole life paid up at 65 is relatively small at younger ages. In many cases, it is worth this small difference to remove the obligation to make payments after employment ends. The other side of the issue is that death ends the premium payment obligation, and it is unlikely to pay premiums until age 100. Whole life paid up at 65 involves more savings than continuous premium whole life, and all the arguments for and against saving with whole life apply to this decision as well.

## D. The Workings of Whole Life Insurance Policies

Whole life insurance tops the list of products that are difficult for consumers to understand. Whole life is a hybrid that combines insurance and a conservative investment. If premium payments start at \$2,000 per year, that's what the [policyowner](#) will pay as long as premiums are due. If he or she cannot pay the premium in a given year, the policy will [lapse](#), and the policyowner will get the cash value back, minus any surrender charges. If the policy has been in force long enough and has an automatic premium loan provision, it is possible that the cash value of the policy can continue the coverage until the cash values are exhausted.

In addition, this individual is likely to lose the full amount of premiums that he or she has paid if the policy is canceled in the early years. This is because the cost of writing these policies (agent's commission, underwriting fees, and expenses) are front-loaded. The cash value of the policy is likely to remain a fraction of what is paid in premiums for several years.

Many people have common goals for their future: starting a family, buying a home, sending a child off to college, and looking forward to a comfortable, worry-free retirement. Any or all of these events may be in the future, and all require careful planning. It's never too early or too late to start planning, but one first needs to understand the mechanics of the whole life [insurance policy](#).

With whole life insurance, part of the premium goes toward the insurance portion of the policy, a part goes toward administrative and operating expenses, and the balance goes toward the cash value portion of the policy.

About 17% of whole life consumers cancel within the first 2 years, according to the American Council of Life Insurance in Washington, D.C. The biggest problem with whole life insurance is that the [policyowner](#) does not know how fast the invested portion will grow because he or she does not know in advance the rate of return that the money is earning, nor how much of the premium is actually credited to cash values. The insurer gives just one guarantee on the investment portion of the policy: the cash value will earn interest at the guaranteed rate at the minimum, probably 3% or 4%. As investments go, that may not seem like much of a return.

Whole life is a higher-premium life insurance than term insurance. The policyowner pays a higher premium up front. So the younger an individual is, the less he or she will pay to maintain the same amount of **death benefit** throughout a lifetime. Whole life insurance builds cash value inside the policy and has guarantees in writing of what the cash value minimums will be as years go by. The owner has no control over how the savings element is invested.

Under a whole life policy, purchasers agree to pay regular premiums to an insurance company in exchange for a guarantee of a specified benefit payable to his or her **beneficiary** upon death. Earnings on a whole life policy are set by the insurance company based on the overall return on its investments. Earnings above and beyond those required to cover the **death benefit** go to the policy's cash reserve, which the **policyowner** can borrow against, withdraw, use to pay premiums, or allow to accumulate for long-term goals such as retirement. Some products combine the lower premium costs of term insurance with the cash value savings element of traditional whole life, which provides a hybrid type of policy.

This cash value build-up is part of the reason the premiums on a whole life policy generally remain fixed for the duration of the policy, instead of increasing to match the increased risk of death. As the cash value within the policy grows, the risk to the insurance company declines. Although the cash value in a policy belongs to the **policyowner**, he or she cannot simply withdraw it as needed. In order to withdraw funds, he or she can either surrender the policy for its cash value or take the needed funds as a policy loan.

PERMANENT LIFE FEATURES	TAX TREATMENT
Premiums	Not tax <b>deductible</b>
Cash value exceeding premiums paid	Taxable at surrender
Policy loans	Not income taxable
Policy dividends	Not taxable
Dividend interest	Taxable in the year earned
Lump-sum <b>death benefit</b>	Not income taxable

## E. Consumer Application

A car dealer has a substantial investment in his car lot and inventory. This year his business is up over 200% and his accountant tells him that he may have an income tax problem. Moreover, he has not saved much money for retirement, nor has he protected his family from the loss of his income if he should die prematurely. In addition, he might want to access some funds at a future date, in case a business opportunity comes along, or he needs money for his daughter's college education in about 10 years.

For a business owner, the premiums for up to \$50,000 worth of group term life insurance may be tax-deductible as a business expense if all employees are covered. Cash values in a whole life policy are usually accessible through loans.

## F. Suitability

### 1. Appropriate Sales

Some planners recommend a combination of cash value and term life insurance to build a complete risk management solution. The term insurance can provide the bulk of the life insurance protection in the earlier years and as premiums rise it can be

reduced to save premiums. At the same time the smaller **face amount** in the cash value policy will provide a level premium which is easier to budget in later years. This strategy requires very detailed planning to make sure that an adequate face amount of coverage is present at all times. If the customer's primary reason for buying life insurance is to provide a **death benefit**, securing an adequate amount of death benefit coverage should be the primary **consideration** for the agent.

For most individuals, the amount of coverage needed is greatest in the early years of building a family because debt is generally higher, income is lower, and children are totally dependent. Over time the same individual will see their need for life insurance decrease as their income rises, debt is paid down, and children become independent. The need for life insurance rarely completely goes away, so one should plan to have some level of insurance for their entire life.

Determining the right amount of death benefit is very important. Families must carefully consider their current and future needs for death benefit to determine whether the needed amount of coverage can be addressed with term, cash value life insurance, or a combination.

## 2. Suitability Checklist

*What are your primary objectives in obtaining life insurance coverage?*

- \_\_\_\_\_ Asset preservation
- \_\_\_\_\_ Debt protection
- \_\_\_\_\_ Death benefit for heirs (liquidity for taxes)
- \_\_\_\_\_ Funeral expenses
- \_\_\_\_\_ Income replacement (major wage earner)
- \_\_\_\_\_ Business continuity
- \_\_\_\_\_ Charitable gifting
- \_\_\_\_\_ Retirement supplement

*Which of the following statements best summarizes your financial objectives?*

- \_\_\_\_\_ My goal is to pay a low premium and have **death benefit** protection for a limited time.
- \_\_\_\_\_ I want death benefit protection and access to cash values for life.
- \_\_\_\_\_ I want to be able to access cash values in the future.
- \_\_\_\_\_ I want death benefit and premium guarantees.
- \_\_\_\_\_ I plan to keep this policy in force for at least 15 years.
- \_\_\_\_\_ I am concerned about inflation and want to take steps to reduce its impact on my future finances.
- \_\_\_\_\_ It is important for me to be able to change the underlying investments in my policy.
- \_\_\_\_\_ It is important for me to be able to increase or decrease the policy death benefit.
- \_\_\_\_\_ It is important for me to have some flexibility in premium payment amounts.
- \_\_\_\_\_ I am comfortable with some risk to principal because it offers the best potential for long-term results.

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## Types of Whole Life Insurance

Let's take a look at some of the types of whole life policies. The first three types of whole life policies discussed are the most basic forms of whole life insurance. They are straight whole life, limited-pay whole life, and single premium whole life, and are classified based on how the **policyowner** pays the premium.

### A. Straight Life

**Straight life**, also known as continuous premium whole life (or traditionally, ordinary level-premium whole life), charges a level annual premium for the lifetime of the insured and provides a level, guaranteed **death benefit**. As any whole life policy, straight life insurance builds cash value. All other factors being equal, straight life policies have the lowest annual premium among whole life policies.

Ordinary level-premium whole life is the oldest form of life insurance protection. If the term "whole life" is used alone, it is generally accepted that the reference is to ordinary level-premium whole life, as opposed to the other types of lifelong policies. Premium payments are level and payable for the whole of life or to age 100.

The policy builds up cash value and, if it is a participating **contract**, also pays dividends. These are values that result from the reserve that the insurer needs to accumulate in the early years of the policy's life so that there will be sufficient money in later years to pay the promised **death benefit** while keeping premiums level. Ordinary level-premium whole life insurance provides a specified death benefit that is paid to the beneficiary when the insured dies. Policyowners who discontinue paying premiums and terminate their policies are entitled to the scheduled cash surrender value, which will be detailed in the nonforfeiture benefits section of the contract.

There are different tax rules for death benefits and living proceeds. Death benefits for all forms of life insurance are usually paid free of any federal income tax. Living proceeds are generally any amounts received during the policyowner's lifetime. A cash value policy typically can generate two types of living benefits that are not present in a term life insurance policy: a policy loan, or a distribution of all cash values upon policy surrender.

Policy loans are generally not taxable because the amount of loan allowed will never exceed the policyowner's income tax cost basis in the policy. The income tax cost basis in a life insurance policy is the total of all premiums paid, plus dividends not paid out in cash, less any outstanding loans; basically, the total of all premiums paid. If a policyowner surrenders a cash value, there will not be income tax due unless the amount of cash values paid to the policyowner exceeds the income tax cost basis of the policy.

## B. Limited Pay Whole Life

A variation on straight life is **limited-pay whole life**. The only difference between straight life and limited-pay life is that, as the name implies, a limited-pay policy specifies a set number of years during which the **policyowner** must pay premium. After the premium is paid up, the policy remains in force for the insured's lifetime. Two common examples are a 10-pay life, in which the policy is paid up after 10 years of premium payments, and limited-pay to age 65 (or LP65), in which the policy premium is calculated to be paid up by the insured's age 65. Again, the policy then stays in force for the remainder of the insured's life.

Limited-pay policies usually have higher premiums than straight life policies because the premium payment period is condensed. Because the premiums are higher, limited-pay policies accumulate cash value more quickly and continue to build cash value after the premium payment period ends.

LP65 policies are becoming more common as people decide they want life insurance coverage during retirement, but don't want to pay premiums during retirement.

## C. Single Premium Whole Life

Another type of policy that relates to the way the premium is paid is called **single premium whole life**. These policies use a one-time, lump-sum premium payment to provide a level **death benefit** to the maturity of the policy. Single premium policies generate immediate cash value because of the size of the lump-sum premium payment. This type of policy often is purchased with the death benefit of a previous policy or with an employment severance package. An interest rate is applied annually to the cash value.

The way these policies differ from other traditional whole life policies is that they are subject to a surrender charge if the policy is surrendered within a certain time period. Generally, the surrender period is 7 to 10 years on a diminishing basis. In other words, the charge will be higher if the policy is surrendered in year 3 than if it is surrendered in year 7.

## D. Current-Assumption Whole Life

**Current-assumption whole life** could be called a hybrid of traditional cash-value whole life insurance and universal life insurance. It is similar to a traditional whole life policy in that, at the time of issue, the premium and the **death benefit** levels are fixed. On the other side of the policy is the universal life characteristics, with separate interests and charges channeled to the accumulation account.

Current-assumption whole life is utilized when an individual wants the fixed-premium, "forced-savings" feature of traditional whole life and the potential for better investment results than those guaranteed in traditional policies. Current-assumption whole life insurance policies have a minimum guaranteed cash value accumulation, but the **policyowner** bears the risk that the investment performance and mortality experience of the company could be less favorable than originally assumed.

The tax rules on current-assumption whole life insurance policies are similar to other types of life insurance policies. These policies are subject to the same income, estate, gift, and generation-skipping **transfer** taxation rules as all other types of life insurance policies. Death benefits generally are paid free of federal income tax.

Living benefits from current-assumption whole life insurance policies also are taxed in the same manner as living benefits from any other life insurance policies. Annuity-type distributions are taxed by calculating an exclusion ratio as provided by Internal Revenue Code Section 72, which states that the policyowner's investment in the **contract** is recovered ratably over the expected payout period.

Other types of living benefits such as partial surrenders or policy loans generally are taxed under the "cost-recovery rule." Only after the policyowner's investment is fully recovered are additional amounts treated as taxable interest or gain in the policy.

An important exception to the general cost-recovery rule is for withdrawals within the first 15 years after the policy issue date that are coupled with reductions in death benefits. Because death benefits are generally reduced in an amount equal to any withdrawal of cash values, these withdrawals generally will be fully or partially taxable to the extent of gain in the policy.

Most current-assumption policies have low or no initial charges or front-end fees. Rather, most of the entire first year's premium is added to the cash accumulation account and begins to earn interest immediately. The commission and other startup costs of issuing any new policy are considerably large, and these have to be recovered.

The surrender charge can be determined explicitly by looking at the policy illustration or ledger statement, which shows both cash value figure and net cash value figures for each of the policy years. The **cash value** is the amount on which interest credits are based. The **net cash value** is the amount that the insurance company would pay if the policy were surrendered. This difference is the **surrender charge**. There are also other charges, such as ongoing administrative expenses and state premium tax expenses.

## E. Interest-Sensitive Whole Life Insurance

**Interest-sensitive whole life** is also known as adjustable life or current interest whole life. This policy allows a **policyowner** to adjust the **face amount**, premium, and length of protection without having to complete a new **application** or request issuance of a new policy. In later years, a policyowner may adjust the premium, face amount, or period of death protection to meet current needs.

With interest-sensitive whole life insurance, the temporary protection could be changed to permanent coverage, and the **death benefit** or the **face amount** could be reduced because of the policyowner's age and premium commitment. The premium for a whole life policy is determined based on certain assumptions regarding company investment, mortality, and administrative experience. The premium for interest sensitive whole life is determined the same way. However, where other premiums are fixed for the life of the policy, interest-sensitive premiums are fixed for only one year.

Interest-sensitive policies contain guarantees that the interest paid on the cash value will not fall below a certain rate, and the mortality charge will not rise above a specified amount. Some policies tie the price of the premium to the interest rates being earned. Thus, if the interest rate is high, the price of the premium will go down. If the interest rate is low, the premium will go up. In such policies, there will be a maximum premium than can be charged.

Interest-sensitive whole life policies may have fixed or flexible premiums and death benefits. These products generally do not pay dividends explicitly but may pay implicit dividends. Instead of receiving an actual dividend payment:

- The policy may be credited with excess interest;

- Lower mortality charges may be deducted from the cash value; and
- A sales load may be waived after a certain period of time.

## F. Modified Premium Whole Life

**Modified premium whole life (MPWL)** is a life [insurance policy](#) featuring a lower initial premium that remains level for the policy's first years (usually 5 years), then increases to its ultimate premium in year 6, and remains at that level for life. It is best suited for established individuals seeking a large amount of insurance and moderate cash value accumulation at a reduced premium.

MPWL policies provide permanent life insurance protection and lower premiums during the first 5 years. They also accumulate tax-deferred, guaranteed cash value. The loan provision allows the [policyowner](#) to borrow from the guaranteed cash value. The policyowner is eligible for dividends if the policy is a participating policy and when declared by the company. Then the [death benefit](#) may increase annually with paid-up additions purchased from dividends. In most instances, this death benefit is free from federal income tax.

In business planning, an MPWL policy can provide for the smooth transition of a business upon the death of a partner when combined with a buy/sell [contract](#). It can also provide an employee benefit. A business can use it as a split dollar arrangement by covering an employee with an [insurance policy](#) with premiums paid by the employer. The employer owns the policy, but the employee can name the [beneficiary](#).

Upon the death of the employee, the employer receives proceeds equal to the cash value of the policy, while the beneficiary receives the remaining proceeds. An MPWL policy offers deferred compensation to employers so that they have the opportunity to provide benefits to employees at a later date (upon retirement, for example). It can also offer salary continuation, giving employees supplemental retirement and death benefits. A buy/sell agreement will be funded through a life insurance plan.

## G. Second-to-Die Whole Life Insurance

**Second-to-die whole life insurance** insures two people, typically a husband and wife, and provides a [death benefit](#) to the beneficiary upon the death of the second insured. These plans are designed to provide cash to cover estate taxes or business liability considerations that have to be paid after both people have died. Second-to-die insurance contracts are usually variations of OL, GPL, and universal life. One important advantage of a second-to-die contract is that its dual coverage costs less than purchasing two separate policies. The policy is designed to provide funds to cover estate taxes due when the second spouse dies. These plans can be based on either whole life or universal life. The heirs of the estate are usually beneficiaries of the second to die policy because they can use the tax-free death benefit to pay estate taxes and other estate settlement costs.

## H. Fixed Premium Whole Life

A **Fixed Premium Whole Life** plan is designed to provide solutions to a variety of life insurance needs: a moderate amount of coverage for small children, a basic plan for young adults to build upon, and small amounts of insurance on members of associations who do not have an employer/employee relationship. An important use of this plan is to provide payment of final medical care, hospital, legal, and funeral expenses, which is an often overlooked need with older adults. A fixed premium whole life policy is a permanent plan that provides a level amount of protection and level

premiums until age 100. The plan includes a built-in cash value that is guaranteed to increase at 4.5% for the life of the plan, which adds an important living benefit to the coverage. The benefits of the fixed premium whole life policy may add the guaranteed **insurability** benefit to ensure the purchase of additional insurance at ages 25, 28, 31, 37, and 40, or when specific events occur, such as college graduation, marriage, home purchase, or the birth/adoption of a child.

## I. Advantages and Disadvantages of Whole Life Insurance

Whole life insurance has many advantages and disadvantages, depending on the situation of the insured individual. Because these situations vary to such a great degree, an insurance agent must look closely at these factors, as disadvantages to some people may actually be advantages for others, and vice versa.

### 1. Advantages

Whole life policies provide the following **advantages** to the policyowners:

- A guaranteed ceiling on mortality and expense charges and a guaranteed floor on interest credited to cash value;
- Safety due to close regulatory supervision of company solvency;
- An opportunity for investment management because life insurance companies provide skilled personnel and broadly diversified investment portfolios;
- Cash value interest or earnings accumulate tax-free or tax-deferred, depending on whether gains are distributed at death or during lifetime;
- Cash values are not subject to the market risk associated with longer-term municipal bonds and other longer-term fixed income investments;
- Regular savings are encouraged as an additional advantage for those saving with a whole life policy;
- Favorable tax treatment is a relative matter, depending on changing individual circumstances and investment alternatives;
- Life insurance policies can be used as collateral or security for personal loans.
- Permanent insurance protection for the "whole" of life;
- Life insurance proceeds are not part of the probate estate if named as the **beneficiary** of the policy; and
- Interest accumulated through the investment portion of a policy is tax-free until it is withdrawn.

### 2. Disadvantages

The following would be considered **disadvantages** of whole life policies when compared with other types of life insurance products:

- The premium may be unaffordable for persons of limited financial resources.
- Younger individuals are often not able to purchase the amount of **death benefit** needed and will often be underinsured if they choose whole life insurance as their only life insurance coverage.
- Interest paid on policy loans is generally nondeductible.
- If a policy loan is taken, it reduces the death benefit.
- Lifetime distributions of cash values are subject to income tax to the extent attributable to gain in the policy.
- Surrender of the policy within the first 5–10 years may result in considerable loss, because surrender values reflect the insurance company's recovery of sales commissions and initial policy expenses.
- Erosion of purchasing power is present with whole life insurance because of a fixed-dollar savings medium, and it is adversely affected by inflation.
- Heavy front-end expenses accompany whole life policies.
- The overall rate of return on the cash values inside of the traditional whole life **contract** has not always been competitive in a before-tax comparison with alternative investments.

- It is often impossible for a policyholder to determine the true rate of return in a whole life policy since the mortality and expenses deducted from the premium are not disclosed.

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## Understanding Adjustable Life

**Adjustable life** is a flexible-premium, adjustable **death benefit** type of cash value insurance. It is essentially a hybrid of universal life and ordinary level-premium life insurance. Adjustable life combines the guarantees available in whole life policies with the flexibility of universal life. Policyowners are able to adjust their premiums and face amounts but are not provided with guarantees in association with any change.

That gives policyholders certainty over the length of coverage and number of premium payments. This is the insurance industry's first "flexible" policy. It allows an individual to adjust premiums or amounts of insurance to meet changing needs.

### A. Definition of Adjustable Life Insurance

**Adjustable life** insurance is cash value insurance that after the initial payment allows a **policyowner** to pay premiums at any time and in virtually any amount, subject to certain minimums and maximums. The policyowner also can reduce or increase the amount of the **death benefit** more easily than under a traditional whole life policy. To increase the death benefit, the policyowner usually must furnish the insurance company with satisfactory evidence of continued good health.

There is no rate manual for adjustable life, and the relationship between the initial **face amount** and the premium determine the nature of the policy. Although often mistakenly called "universal life," adjustable life does not "unbundle" the term insurance from the investment element. The two types of insurance are similar, though, because of their flexible features.

### B. Features and Benefits of Adjustable Life Insurance

The insurance industry has evolved over the years, becoming more flexible to meet the complex and changing needs of today's more sophisticated consumers.

With the premium amount and payment period being flexible, the policy can change to fit future needs. Adjustable life has most of the options of other cash value contracts.

#### 1. Cost of Living Agreement Feature

The **cost of living provision** is an automatic benefit with most adjustable life policies. This provision allows an individual to increase the **face amount** of the policy in order to help keep pace with inflation. It is usually offered every 3 years on the policy anniversary and allows for inflation based increases in the policy face amount without proof of **insurability**. With most cost of living provisions, the insured will lose the ability to elect the periodic increase in benefit without proof of insurability if they ever elect not to take one of the cost of living increases.

## 2. Lengthen or Shorten the Protection Period

With an adjustable life policy, similar to traditional cash value policies, the pure protection and savings components are not segregated. For a given premium payment plan, the cash value schedule is set, and withdrawals generally are not permitted without a complete or partial surrender of the policy, or a policy loan. Many cash value policies today and most adjustable life insurance policies are indirect-recognition interest-sensitive or indirect-recognition current-assumption policies.

## 3. Non-Repeating Premiums

Adjustable life's design allows a **policyowner** to make "unscheduled" payments directly to the cash value. Such payments will lengthen the term of coverage or shorten the premium-paying period, depending on whether the current insurance plan is in a term or a whole life mode. A large enough payment might change a plan from "term to age 50" to "term to age 65" or from a "life paid-up at age 75" to a "life paid-up at age 65." Some insurance companies may restrict the availability of this feature in the first few policy years.

## 4. Policy Flexibility

Adjustable life lets policyowners adapt their policies as the answers to these questions evolve during their lives:

- How much insurance do I need?
- How much premium can I afford?
- Do I need protection to a certain age or for a lifetime?

## 5. Guaranteed Insurance Coverage

Depending on cash flow, protection needs, and personal and business goals, adjustable life insurance can (within limits) evolve as needs change. With this flexibility, adjustable life insurance can meet many current and future life insurance needs.

A limited protection plan can be set up for 5 years with low premiums to meet these needs. Between each adjustment period, the policy is a level-premium, level-death-benefit policy. Depending on the particular premium and **death benefit** levels that a **policyowner** may choose, the policy can assume the form of almost any traditional term or whole life policy. Even though the plan of insurance can be changed, adjustable life insurance is basically a traditional fixed premium, fixed benefit policy. Some of the items that are up for **consideration** are the policy loan provisions, policy loan interest rate, and whether the company uses a direct recognition method to determine the dividend paid on policies with policy loans.

Other points to evaluate are the adjustment provisions and commonly offered guaranteed **insurability** options. It is best to get policies that have more liberal adjustment provisions. Policies that permit more frequent changes in the plan and permit them sooner after the policy issue date are at the top of the list. However, the more liberal the adjustments provisions are, the more involved they will be, and they will usually have higher expense charges.

Another key **consideration** when choosing an adjustable life policy is the level and quality of service of a particular insurance company. Since these policies are designed to allow frequent adjustments to meet the changing needs of a **policyowner**, the quality of service should be a selection criterion. Changes require re-computing the premium payment plan, cash value schedules, and projected dividend schedules. This may also involve a new underwriting evaluation if **insurability** is required.

This service comes from the insurance company and the agent. Both of these entities should be considered and investigated. If either takes several weeks or months to make a change that a **policyowner** has requested, this can be more than annoying to an individual who is anxious to make an adjustment.

## C. Varieties of Adjustable Life Insurance

### 1. Charitable Adjustable Life

**Charitable adjustable life (CAL)** is specially designed to help secure endowment funds for the future. It's important that the future financial strength of these nonprofit organizations is secure. CAL is simple, effective, and makes sense for nonprofit organizations. After a nonprofit organization has secured a group of interested donors, the donors fill out a medical form, and an insurance representative provides a letter of intent to the organization. When the organization receives all premiums/donations, it sends a check for the total to the insurance company.

Nonprofit organizations face increased demand for services in the wake of reduced government support and high operational costs. CAL can help ensure the well-being of individual nonprofit organizations by creating a pool of monies to meet future funding needs. CAL is a simple permanent life **insurance policy** with competitive interest crediting. As the owner and **beneficiary** of the policy, individual nonprofit organizations have access to any cash values that accrue which can be a positive for a charitable organization if an unexpected need for liquidity arises.

In the past, it was common for charitable organizations to rely heavily on a handful of wealthy donors. Because CAL is affordable, those limited to making smaller donations may now be able to fund sizable gifts. CAL is not intended to replace the current fundraising efforts of charitable organizations, but it can help to secure funds to meet longer-term needs. Since this involves a charitable organization being named as **beneficiary** of a life policy, the charitable organization must have an **insurable interest** in the life of the donor.

### 2. Variable Adjustable Life

**Variable adjustable life (VAL)** provides a **policyowner** with potentially greater wealth than offered by traditional insurance policies, along with features that give control over a life insurance program. A full range of investment subaccounts allows people to earn a potentially higher rate of return on cash values than traditional policies and diversify dollars to suit risk and return objectives.

The cash value of a VAL policy will vary depending upon the performance of the underlying subaccounts and may be worth more or less than the original amount invested in the policy.

### 3. Employees Adjustable Life Insurance

Various insurance companies, in cooperation with thousands of employers across the country, offer a program that assists employees in providing protection and financial security for themselves and their families. The **employees adjustable life insurance** allows employees of participating companies to purchase individual universal life insurance coverage through voluntary payroll deduction. Here are a few of the characteristics of employee adjustable life insurance:

- Because this program is not intended to be subject to ERISA, participating employers cannot contribute to or endorse any policy offered under this program.

- This policy is available to employees of participating companies. Through payroll deduction, an insurance company is able to offer rates that are competitive.
- Employees can adapt their plan to accommodate their changing needs throughout the years. Premiums can be adjusted to satisfy an employee's new needs and/or budget. The policy provides increasing cash value, which may be used for emergencies, retirement, college education, or other financial needs. Employees also have the option to increase or decrease the policy [death benefit](#) or cash accumulation value without purchasing an additional policy.
- Completion of a short [application](#) is usually all that is needed. Physical exams are usually not necessary. Individual employees own their policies, so they can tailor them to meet their own needs. Should employees leave their employer for any reason, they can continue their policy without any change in premiums or benefits.

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## Workings of Adjustable Life Insurance

Even though adjustable life is a flexible-premium type of cash value insurance and can take on the form of almost any traditional term or whole life policy, it provides less flexibility to adjust premiums and death benefits than a universal life policy.

Generally, universal life policyowners may vary their premiums at will or skip premium payments altogether if the policy has sufficient cash values to cover mortality and expense charges. Adjustable life insurance policies cannot be set to zero without policy **lapse** or invoking the automatic policy loan provision, unless the policy is in paid-up status. The minimum annual premium is typically equivalent to the premium for a 5-year term policy. In contrast to universal life insurance, once a policyowner has selected a given plan of insurance, premiums must be paid as scheduled unless the policyowner notifies the insurer of a desire to change the insurance plan. These advance requests for change in the premium payment plan, **face amount**, or duration of coverage may be limited or restricted to specific dates or intervals.

Because adjustable life insurance earns dividends rather than interest, it is important to understand how dividends work. Adjustable life is a "bundled" product, which means that expenses, mortality assumptions, and the company's investment performance are lumped together when determining the rate at which dividends are credited. The advantage of dividends in the adjustable life insurance product is that policyowners can receive dividends in a variety of ways. Dividends can be:

- Applied to increase cash value. This option lengthens the protection period or increases face amount;
- Used to shorten the payment period so the policy becomes paid-up sooner; or
- Accumulated with interest or taken in cash.

The dividend option can be changed at any time, depending on the customer's needs.

Adjustable life insurance offers conventional dividend options, such as cash, premium reduction, accumulate at interest, and paid-up additions. Some policies also offer what is called a **policy improvement dividend option**. With this option, the dividends become part of the cash value and lose their separate identity afterward. If the plan of insurance is equivalent to some form of whole life insurance, this option causes the **face amount** to increase without an increase in premiums or changing the premium-paying period.

If a **policyowner** decides before 5 years are up that he or she wants a lifetime protection policy, this is not a problem with adjustable life because the premiums can be increased and dividends can be used to lengthen the protection period. As his or her income increases, he or she can decide to increase the coverage to fit a new lifestyle.

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at specified intervals and periods, the policyowner can choose to:

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With an adjustable life policy, the costs of administration, recordkeeping, and service are generally somewhat higher. It is also possible for the insurance company to face greater risk of **adverse selection**. Policyowners have more latitude to exercise their rights to increase or decrease the face amounts and reduce premium payments without reducing the face amount when health declines.

Considering all of these aspects, expense charges and mortality charges tend to be somewhat higher in these policies than in otherwise compatible fixed-premium, fixed-benefit policies. Life insurance companies are free to set their premiums according to their own marketing strategies. The premium includes a loading to cover such things as commissions to agents, premium taxes payable to the state government, operating expenses of the insurance company (such as rent or mortgage payments and salaries), and any other applicable expenses.

Most of an insurance company's expenses for a policy are incurred when the policy is issued. It may take the company 5 years or longer to recover all front-end costs. The state premium tax is an ongoing expense that averages about 2.5% of each premium payment. Some insurance companies pay 55% first-year commissions to the agents when the plan of insurance is similar to an ordinary whole life policy.

In the case that the insurance company offers a "no-load" or "low-load" life **insurance policy**, there are still certain expenses that are unavoidable. Rather than pay no or very low sales commission, the cash value tends to build up larger in the early years. Even though the commissions are lower, these companies typically must spend more money on alternative methods of marketing and may therefore incur higher expenses in this area than companies that pay commissions to agents. Many of the adjustable life policies have no explicit surrender charges. However, some will pay a terminal dividend when the policy is surrendered.

The terminal dividend is typically higher the longer the policy has remained in force. This is really a form of surrender charge, because the company is holding back dividends that it could otherwise pay. This rewards policyowners who maintain their policy longer with a greater terminal dividend.

## B. Adjustable Life Insurance and Taxation

Generally, policies are taxed in much the same manner as other life policies. Death benefits do not usually have federal income tax consequences. Adjustable life insurance policies are subject to the same income tax and estate, gift, and generation-skipping **transfer** taxation rules as all other types of life insurance policies. Living benefits from adjustable life insurance policies are also taxed in the same way as living benefits for other life insurance policies.

Except for annuity-type distributions, living benefits are generally taxed under the cost recovery rule. The **cost recovery rule** is sometimes called the **first-in-first-out rule**. This rule treats amounts received as nontaxable recovery of the policyowners

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## C. Adjustable

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receive a MEC classification penalty. Under the MEC classification, the distributions are taxed under the interest-first rule rather than the cost recovery rule. If the distributions occur before the **policyowner** is 59½, dies, or becomes disabled, there will be an additional 10% penalty.

A MEC classification results in a faster taxation of investment gains and a possible penalty tax for early receipt of that growth. The non-annuity living benefits, such as policy loans, loans secured by the policy, loans used to pay premiums, and dividends taken in cash, are the **contract** distributions referenced in the preceding paragraph. Not included in the contract distributions are dividends used to pay premiums, dividends used to purchase paid-up additions, dividends used to purchase one-year term insurance, or the surrender of paid-up additions to pay premiums.

There are certain changes that can take place in adjustable life insurance that cause it to fall into a MEC classification:

- A material increase of the death benefit;
- An increase in the premium payments;
- A change in the plan of insurance; or
- A reduction in the death benefit.

## D. Adjustable Life Insurance and Business Insurance

Adjustable life also can be a great product for funding business plans. The flexibility of an adjustable life policy makes it suitable for many business life insurance needs.

Adjustable life offers a conservative and guaranteed vehicle for all sorts of business applications in which adjustments in death benefits or cash accumulations are frequently required, including split dollar plans, nonqualified deferred compensation plans, death benefit only plans, key-person insurance, buy-sell agreements, retiree benefits funding, and qualified retirement plans that use insurance.

A salary increase  **rider** can be attached to adjustable life policies to increase the **face amount**, using a multiple of salary. *For example*, if the face amount is two times the salary, as an executive's salary increases, so would the face amount of the policy. The executive bonus plan allows the business owner to bonus the amount of premiums to the employee, thus treating it as compensation and receiving a current tax deduction for the business.

## E. Advantages and Disadvantages of Adjustable Life Insurance

As life changes, so do financial goals and the need for protection. Adjustable life can help simplify insurance coverage by offering lifelong flexible coverage in a single policy. This means the **policyowner** has only one policy to deal with — one premium notice, one set of cash values, and one **beneficiary** designation. Policyowners save money because costly policy fees aren't paid for additional policies.

### 1. Advantages

Adjustable life policies provide the following advantages to the policyowners:

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  - Allowing a policyowner to take advantage of tax-deferred growth. At any time, the policyowner can accelerate cash value growth and build toward specific long-term financial goals by paying in addition to regular premiums.
  - Giving a policyowner a competitive return on cash value. Adjustable life insurance invests cash value at market rates.
  - Free transfers between subaccounts allow the policyowner to adjust the investment strategy according to personal goals and priorities.
  - Access to cash values through policy loans and partial withdrawals. Loans and withdrawals may reduce the cash value and [death benefit](#) of the policy.
  - The requirement to pay scheduled premiums under the selected plan of insurance provides a “forced saving” feature.

## 2. Disadvantages

Although adjustable life policies offer certain flexibility and convenience to the [policyowner](#), it still contains too many elements of traditional life insurance policies. The following would be considered disadvantages of adjustable life policies compared to other flexible premium policies:

- Surrender of the policy within the first 5 to 10 years may result in considerable loss, because cash surrender values reflect the insurance company’s recovery of sales commissions and initial policy expenses;
- Restrictive withdrawal rules;
- Flexibility to change premium payments and death benefits may inadvertently cause the policy to become a modified endowment [contract](#) (MEC) with adverse tax consequences;
- Lifetime distributions or withdrawals of cash values are subject to income tax to the extent attributable to gain in the policy; and
- Interest paid on policy loans is generally nondeductible.

Since the development of universal life products, there are now few insurers that market adjustable life policies.

## F. Consumer Application

*Scenario #1:* A real estate [broker](#) specializes in large ranch properties. This year he has sold more properties than any other year and acquired some investment properties, financed with long-term, fixed-interest mortgages. He does not want to commit to long-term payments because his sales commissions fluctuate year to year, but he wants to protect his estate from estate taxes while covering the substantial mortgages he just started. He hopes to buy more properties in about 3 years, which will increase his need for protection. Often in his career he has needed access to his money relatively quickly in order to “close a deal.” He is concerned that more investments might mean that he would have to pay more in income taxes, which he does not want to do.

Adjustable life allows flexible premiums and tax-deferred cash accumulation. Many adjustable life plans allow an increase in [face amount](#) after 3 years, so the broker could increase his coverage when he acquires more mortgages. The plan also allows for a face amount decrease when his obligations are lower. Loans allow him to access cash values.

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The nonprofit could secure charitable adjustable life (CAL) on its members. After the donors complete a simple medical form and give donations, the organization establishes the CAL. Later, the cash values are available to the organization, and upon the members' demise, the **face amount** goes to the organization.

## G. Suitability

### 1. Suitability Checklist

*What are your primary objectives in obtaining life insurance coverage?*

- \_\_\_\_\_ Asset preservation
- \_\_\_\_\_ Debt protection
- \_\_\_\_\_ Death benefit for heirs (liquidity for taxes)
- \_\_\_\_\_ Funeral expenses
- \_\_\_\_\_ Income replacement (major wage earner)
- \_\_\_\_\_ Business continuity
- \_\_\_\_\_ Charitable gifting
- \_\_\_\_\_ Retirement supplement

*Which of the following statements best summarizes your financial objectives?*

- \_\_\_\_\_ My goal is to pay a low premium and have **death benefit** protection for a limited time.
- \_\_\_\_\_ I want death benefit protection and access to cash values for life.
- \_\_\_\_\_ I want to be able to access cash values in the future.
- \_\_\_\_\_ I want death benefit and premium guarantees.
- \_\_\_\_\_ I plan to keep this policy in force for at least 15 years.
- \_\_\_\_\_ I am concerned about inflation and want to take steps to reduce its impact on my future finances.
- \_\_\_\_\_ It is important for me to be able to change the underlying investments in my policy.
- \_\_\_\_\_ It is important for me to be able to increase or decrease the policy death benefit.
- \_\_\_\_\_ It is important for me to have some flexibility in premium payment amounts.
- \_\_\_\_\_ I am comfortable with some risk to principal because it offers the best potential for long-term results.

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## Universal Life Insurance Overview

Universal life insurance provides insurance protection with the guarantee against **lapse** as long as the insured pays a certain premium amount. Two different universal life insurance policies have a guaranteed minimum interest crediting rate, plus features that can be adjusted as the person's needs change and riders that can be added to customize coverage.

### A. Defining Universal Life Insurance

Universal life is a cross between term insurance and whole life with an investment fund that generally has a minimum earnings rate. The premium is flexible, giving the insured the option of adjusting it from year to year, paying a lower or higher premium amount, and even skipping premium payments, as long as the cash value is sufficient to cover all of the costs of the insurance.

The amount of insurance can be changed as circumstances change throughout life. Consequently, the **death benefit** can be raised or lowered, although increases in the death benefit may require proof of **insurability**. The policy is interest-sensitive, meaning that a credit of the current interest rate is applied to policy values.

Universal life contracts separate the protection, expense, and cash value elements. Dividing the policy into these three components allows the insurance company to build a higher degree of flexibility into the contract. This flexibility allows the **policyowner** to modify the policy **face amount** or premium in response to changing needs and circumstances.

A monthly charge for the protection and expense elements is deducted from the policy's account balance. The remainder of the premium is allocated to the cash value element. Complete **disclosure** of internal charges against the cash value element is provided to the policyowners in the form of an annual statement.

In many situations, the combination of low term insurance rates, a competitive yield on cash value, and tax benefits makes the universal life **contract** a viable alternative to more conventional insurance approaches.



## B. Front-End and Back-End Loads Feature

A **front-loaded policy** is a universal life [insurance policy](#) in which most of the expense charges take the form of deductions from each premium payment. Such deductions continue throughout the premium payment period and include annual administrative fees, a premium tax in some states, an annual mortality and risk-expense guarantee fee, and the management fees for running the investment funds.

A **back-loaded policy** is a universal life [insurance policy](#) in which most expense charges occur only if and when the [policyowner](#) surrenders the policy or makes cash withdrawals from the policy. Such charges are usually highest in the early policy years and often are eliminated at the end of a certain number of years.

Initially, universal life products came with **front-end loads**, which are the acquisition expenses taken out of the first premium payment(s). Subsequently, many companies have changed to a back-end load format, in which penalties are applied if the product is canceled during the early years. For a period of time, the cash account will be lower than the accumulation account. This is because universal life is usually back-loaded. Until the expense load has been paid, the money that can be withdrawn is less than the total earned in the reserve account. Once the two merge, the load has been paid in full.

The result of front-end loads will be seen in the first couple of years in a universal life policy because the cash value is equal to zero when the insurance company deducts certain expenses. Over the life of the policy, however, there is a steady increase in the amount of the cash until the age of maturity, when the cash value is equal to or exceeds the policy's [face amount](#).

The big attraction to universal life policies was the high advertised interest rates being paid on the savings portion of policies. The [policyowner](#) will have a front-end load charge for commissions on each contribution. There will not be a front-end load if part of the contribution is used to pay policy premiums. Other front-end loads may include

annual administrative fees, a premium tax in some states, an annual 1% mortality and risk-expense guarantee fee, and the management fees for running the investment funds. Two cash accounts are kept on a universal life policy: an accumulation account and cash value.

This is because some universal life is **back-loaded**. This means that expenses such as commissions, which are usually front-loaded in whole life or term life, are only charged in the event of a withdrawal or surrender in the universal life policy.

Of course, a policyowner can elect to have a front-loaded policy. However, until the expense load has been paid, the money that he or she can withdraw is less than the total earned in the reserve account. Once the two merge, the load has been paid in full. Universal life policies allow a policyowner to increase the coverage without loading the costs and expenses all over again. The insurer will, however, have the right to make sure that an individual remains insurable. Universal life insurance policies are more easily unbundled, so each month the policyowner receives a statement showing the front-end and back-end loads.

## C. Features and Benefits of Universal Life Insurance

Universal life insurance separates the **death benefit** feature from the investment feature and offers increased flexibility for premiums. In a typical universal life policy, the insured may raise or lower the premiums on an annual basis, making this type of policy more of an investment vehicle than pure insurance.

An attractive feature of universal life insurance is that the insured can vary his or her annual **death benefit** and premium. Additionally, the insured may make partial surrenders of and take policy loans against the cash value of the policy. In years when earnings are good, the insured can put more money in the cash portion of the policy and get a faster buildup of the cash value. In years when earnings are not as good, the insured may skip paying the premium altogether or pay less than the total premium.

If the insurance company can offer a high return, an insured may want to raise his or her contributions to the policy to earn the better return that accumulates tax deferred. In a whole life policy, the insurance company essentially guarantees a fixed rate of return on the built-up cash value. In a universal life **insurance policy**, the company adjusts the interest rate from time to time. This adjustment in the rate of return allows the universal life policy to stay competitive when rates on alternative investments are rising.

Many universal life policies also will allow the insured to determine whether to allocate policy premiums to the **death benefit** or to the investment feature of the policy. Universal life policies often do not require repayment of a policy loan.

The following are **advantages** of universal life:

- It is a cash value policy, which can provide cash to offset increase mortality charges as the insured ages.
- It has the features of business insurance and individual coverage.
- It is a flexible **contract**, allowing the insured considerable latitude in selecting a premium payment amount and a **death benefit**. Most individuals or families experience financial ups and downs and it can be beneficial for a **policyowner** to be able to omit premium payments for a year or two when finances are tight.
- The inside buildup of universal life insurance is tax-deferred.
- It has flexible investment options for the policyowner. This is a decision made not only on the day an individual decides on a specific **face amount** of life insurance

and puts the policy in force; it continues to be an important decision throughout the life of the contract.

- The funding strategy can be divided into the following 6 levels (described in detail later):
  - Underfunding;
  - Parity funding;
  - Minimum funding;
  - Adequate funding;
  - Investment funding; and
  - Maximum funding.

Additionally, Universal Life, like many other life insurance products, provides protection from creditors' claims, offers a [policyowner](#) loan provision, provides tax benefits if the policy matures as a death claim, and offers a semi-compulsory savings feature with professional money management.

Universal life generally has lower premiums than whole life but gives policyowners many of the benefits of whole life, including cash build-up values, control over the level of premium payments, and control over the amount of their death benefits. The tradeoff is that the cash build-up of universal life policies is not necessarily fixed or guaranteed, as with traditional whole life policies. Instead, it is linked to the performance of the funds in which premium dollars are invested.

## 1. Types of Funding

**Adequate funding level:** Adequate funding is a level of payment designed to allow the [policyowner](#) to arrive at parity funding at some particular point in time. **Adequate** is an amount of money that covers all current expenses and mortality charges and also makes a significant investment into the policy. *For example*, if approximately \$6,000 in capital is needed to reach parity funding and an individual does not have \$6,000 to put into the policy immediately, that individual may decide on an investment of \$100 per month or \$1,200 a year.

**Underfunding level:** Underfunding of universal and variable universal life policies occurs when the mortality and expense charges exceed the combined total of the investment earnings and current yearly payment into the policy. When the [policyowner](#) examines the policy, he or she may find that expenses incurred for the year were \$50 and mortality costs were \$450, totaling \$500 in costs for that particular year.

**Parity funding level:** "Parity" is the quality or state of being equal. The primary objective of the life [insurance policy](#) is to provide insurance protection on the life in the amount deemed necessary. The [policyowner](#) will want to pay for this insurance in the most efficient way possible. The **parity funding level** in a life insurance policy is the point at which the amount of capital invested inside the policy will earn enough nontaxable return in the year in question to pay all of the mortality and expense charges within the policy in that year. There is "parity" between policy earnings and policy costs.

**Minimum funding level:** The minimum funding level should be the level at which the interest earnings in the policy and the policyowner's contribution to the policy are no less than the amount of the mortality and expense charges in the policy in that particular year. Such a funding level will ensure that the capital accumulated within the [contract](#) will stay at a constant level for the year and will not be depleted by policy costs. It's an advantage to own a policy where a policyowner can adjust the premium

level back to that of a straight term policy during those times when he or she does not have extra money to invest in the policy.

**Investment funding levels:** If a [policyowner](#) has reached the parity funding level, and policy earnings are sufficient to cover all policy expenses, why would he or she choose to invest even more capital into an investment fund? A policyowner would do that to earn more for himself or herself, for an emergency fund, for college education funds, and for eventual retirement, taking advantage of the protection from income taxes provided by the policy. Many participate in successful mutual funds and use them appropriately to build family wealth. Such mutual funds outside of the life [insurance policy](#) require the payment of taxes each year on any earnings and capital gains realized.

**Maximum funding:** The maximum funding level is based on the policy [death benefit](#), age, and the person's gender. It is the point at which no additional funds can be added to the policy, based on the controlling income tax provisions in Internal Revenue Code Section 7702. The insurance company will determine what the amount is for each [policyowner](#). According to the tax code, funding above this level causes the policy to cease to be a life [insurance policy](#), resulting in immediate taxation of all deferred earnings. The insurance company should not accept money that would cause the policy to go above maximum funding.

## 2. Death Benefit Options

Universal life has two kinds of flexible death benefits:

1. A level death benefit that remains at a constant level for the life of the [contract](#), regardless of the performance of the cash values. This is the death benefit that is very similar to whole life insurance, in that the cash values are returned at death as a part of the death benefit (usually called **Option A Death Benefit**); and
2. A death benefit that pays the [face amount](#) of coverage purchased plus the accumulated cash value. This is usually called **Option B Death Benefit** and, as you might guess, requires a considerably higher premium outlay.

The Option B Death Benefit not require any future medical or financial justification to be submitted to the insurer for the increase in [death benefit](#) due to the cash value accumulation being paid in addition to the policy [face amount](#). Regardless of which death benefit option is chosen initially, some insurers allow a limited amount of switching between the two after the policy is in effect. The Death Benefit Option elected by the [policyowner](#) directly affects the net amount of death benefit risk that the insurance company is exposed to. The size of the amount at risk, in part, determines the internal amounts charged for the term insurance expense.

Universal life insurance has three areas in which a [policyowner](#) can choose either a level or adjustable option. These three areas are premiums, coverage, and death benefits. The premiums are adjustable by building the cash value so that it can make the entire payment or part of the payments. The coverage is adjustable because of the performance of certain assets held in the company's general account. The death benefit options include Option A or Option B.

Under Option A, the policyowner purchases a death benefit that does not include the accumulated cash values, so the net amount of death benefit risk the insurance company is exposed to decreases as the cash value increases, and the amount of mortality risk that must be purchased decreases. Under Option B, the policyowner purchases a death benefit that includes the accumulated cash values, so the net amount of death benefit risk the insurance company is exposed to does not decrease

as the cash values grow and the amount of mortality risk that must be purchased also does not decrease.

### Option A - Level Death Benefit

Under Option A of universal life insurance, there is a level **death benefit**. A **policyowner** stipulates to the insurance company the total amount of the death benefit that is to be payable to the beneficiaries. If a policyowner stipulated Option A, the investment results in the policy will have no impact on the death benefit.

If he or she has elected \$200,000 as the **death benefit** under an Option A policy, that's exactly what the beneficiaries will receive. If he or she had paid \$50,000 worth of premiums and had investment results that doubled that amount, the account value would be \$100,000. The insurance company would still pay a total of \$200,000, \$100,000 of which would be the account value and \$100,000 of which would be insurance company money.

*For example*, a **policyowner** transfers \$10,000 from a CD into an Option A Universal life **insurance policy**, but dies immediately thereafter. The insurance policy pays \$200,000. The day before, while the CD was still in the bank, he had a \$200,000 life insurance policy and a \$10,000 CD. Had he died at that point, the **beneficiary** would have received both the \$200,000 and the \$10,000 CD. The instant the insurance company received the CD for deposit into an Option A policy, the insurer reduced the "net amount at risk."

For this reason, a **policyowner** should avoid an Option A policy during the accumulation years, unless he or she has a specific reason for selecting this option. The **face amount** is the **death benefit** and includes the value of the investment account. *For example*, the face amount/death benefit is \$200,000 on Option A. The policy account value is \$100,000. The amount at risk is \$100,000. The death benefit will be \$200,000.

### Option B - Increasing Death Benefit

Under Option B, the **death benefit** is equal to a specified amount, plus the policy's current cash value. With Option B, under normal circumstances, the death benefit increases. Consequently, the **face amount** will not change, but the actual death benefit payable will be reduced because of the reduction to the cash value. It is possible to withdraw cash value without affecting the death benefit if the policy is not written in the Option B format. This will shorten the policy's lifespan.

When a policyholder elects Option B, he or she directs the insurance company to pay the stipulated benefit from its money, not the policyowner's money. Instead of having the \$200,000 death benefit included in the investment account, the policyowner asks that the investment account be paid in addition to the amount at risk of \$200,000.

By electing Option B in the previous example, when the individual transferred the \$10,000 into his investment account, that investment account would increase by \$10,000. In the event of death, the life insurance (\$200,000, which is the amount at risk) and the investment account (\$110,000) would be paid to the beneficiary, for a total of \$310,000. The death benefit is the face amount plus the value of the investment account.

A policyowner maintains control over the death benefit with Option B. If he or she wants the insurance company to reduce the amount at risk, he or she can direct the insurance company to reduce the face amount of the policy to the predetermined level. The insurer will do so and thereby reduce the mortality costs. A policyowner

must be cautious about asking for any reductions in the death benefit of the life [insurance policy](#), particularly during the first 15 years of the policy's life.

**Force out** means that there is too much cash in relation to the [face amount](#) of the policy. The insurance company is forced to take money out of the policy and return it to the [policyowner](#) to remain in compliance with the definition of life insurance in IRC 7702. Money forced out in this manner will trigger ordinary income tax on the amount forced out to the extent of gain in the policy, in addition to possible 10% penalties.

The optional solution may be for the policyowner to use Option B in a [contract](#). It is best if the policyowner avoids a reduction of the face amount during the first 15 years of the policy life. It is best if the policyowner considers the potential income tax implications of any changes. When the policyowner works closely with the insurance company and their advisor, he or she will avoid income tax surprises.

## D. Consumer Application

A rising litigation attorney needs insurance to protect her family. Because her children are young and her career is in the beginning stages, guaranteed death benefits are important to her. She expects that her income will increase, along with her taxes. A large case she has just won will settle sometime in the next 2 years. There is also a chance that in 5 years she will take a couple of years off to have another child. She is not particularly good at saving money and, given her area of law practice, would like to shelter assets from creditors. She considers herself an aggressive investor and wants to start a retirement savings.

Universal life gives this insured the option to vary the death benefit and the annual premium. If accumulations are sufficient, the insured can skip payments or pay less than the total premium. The plan offers a semi-compulsory savings feature along with professionally managed funds for her cash accumulation. It can offer some protection from creditors.

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## Universal Life Insurance Features and Benefits

### A. Premium Flexibility Feature

Universal life products use a general investment account, and the individual **policyowner** cannot choose the type of investments desired.

Universal life offers a degree of flexibility that is not available in most other types of cash value policies. The policyowner may decrease or increase the **face amount** of the insurance. Insurability requirements may have to be satisfied if the face amount is increased. Premiums may be changed, as long as enough premium has previously been paid to maintain the policy.

**Flexible premium policy** means that the insured is permitted to control the amount and frequency of payments. The insured has the option to increase the premium or make a lump sum contribution, subject to limits specified in the policy. The extra dollars grow tax-deferred and may increase the cash and **death benefit** values.

Universal life is a banking arrangement, with premiums (deposits) that are entirely flexible after the first year. As with a bank savings account, the **policyowner** can "sock away" as much or as little as he or she likes, or can make no deposit at all. The policyowner can make withdrawals without reducing the death benefit; the company will automatically increase his or her term coverage and pay for it by increasing the monthly premium charge withdrawn from his or her savings.

If the policyowner wants to increase the death benefit, he or she increases the charges for the mortality and/or the expenses to the extent necessary to support the increased death benefit. Likewise, if the policyowner wants to reduce the death benefit, the mortality charges are reduced. Thus, universal life offers flexibility of the **face amount**, so that the policyowner can use one policy and increase or decrease it as his or her life situation dictates, as long as the insured remains able to qualify for any desired increases in coverage.

The policyowner can also choose between two death benefit options by determining the amount and payment schedule of premiums (within policy limitations). Death benefits are paid to the beneficiaries free of income tax. Under current interpretations of federal tax laws, interest earned is tax-deferred until the policy values are distributed.

In universal life insurance, a **policyowner** can add to the investment in the policy by increasing premium payments. At a minimum, the policy must have sufficient monies in it to cover the mortality and expense charges. The maximum a policy can accept is stipulated in the Internal Revenue Code and regulations.

Every month, the insurance company adds any premiums that paid to the existing account's balance and credits interest on that money. Premiums can be changed frequently at the insured's election. However, there are negative ramifications to paying too little premium over a long period of time.

Many consumers reduce their premiums to imprudent levels, causing the cash values of the policy to drop and the insurance to **lapse** or to be prohibitively expensive as the policyowner gets older. The owner of a universal life policy can specify the premium amount that he or she will pay, as long as this amount falls within the minimum and maximum specified by the company.

If the premium is insufficient to pay the policy mortality and expense charges, the balance is taken from the policy cash value. If the premium exceeds the maximum level specified by the company, then the policy's cash value may grow too large in relation to the policy **death benefit**, and the policy will be considered an investment **contract** rather than an insurance contract and fall under the MEC laws. The difference in size that must be maintained between the cash value and the death benefit is called the **corridor**.

In a universal life **insurance policy**, the **policyowner** is permitted to change the policy's death benefit after the policy has been issued, but this right is subject to restrictions. If a policyowner wishes to increase the policy's death benefit, the insurer may require evidence of **insurability**. Secondly, any decrease in the policy's death benefit must not violate the corridor guidelines. Flexible premium annuities let one build an annuity over time.

An individual can make monthly additions for as little as \$50 (\$600 the first year) and can arrange for the monthly additions to be automatically transferred from his or her checking account. This policy can change as the needs of the policyowner change. It can provide life insurance protection and help accumulate cash on a tax-deferred basis. When circumstances change, so can the universal life policy.

## B. Cash Value

At the dawn of the "permanent insurance" 150 years ago, there was no such thing as a cash value. Reserves set aside to cover future claims were the property of the insurance company, not the **policyowner**. If the policyowner could not pay his premium and his policy lapsed, he did not get any money back. The policy's entire reserve belonged to the insurance company. Since there was no perceived value in life insurance if one didn't die, policy lapse rates were very high.

The first thing the insurance industry did to encourage individuals to keep their coverage was they began to offer a "periodic dividend." This periodic dividend was paid every 5 or 10 years (depending on the policy) to anyone who was still alive and paying premiums on their policy (in the **contract** this periodic dividend was paid to "any live policy holder who persisted in owning their policy and paying all premiums when due").

This periodic dividend concept was borrowed from the principle of "tontine" which has its roots in 17th century Europe. The existence of the periodic dividend did encourage persistency of insurance contracts even though the insurance company made no guarantees as to the amount of the future dividend.

Competition resulted in insurance companies making the perceived value more personal than the "periodic dividend" by guaranteeing a minimum amount of the

payment to each policyholder based on the amount of their premiums. Companies decided that if a policy lapsed after it had been in force 3 to 5 years, they would refund part of the reserve if the policyowner canceled. So the insurance industry designed several types of alternative cash value policies to answer critics of permanent life insurance. Thus, cash value was born.

Universal life insurance provides both term life insurance coverage and cash values. The cash buildup is not taxable until it is withdrawn, so it provides a tax deferral mechanism. Premium payments exceed mortality costs during the early years of the policy. The insurer's purpose for the initial "overpayments" is to keep premiums level and affordable during the later years of the policyowner's life. The cash value supports other policy features, such as the policyowner loan provision and nonforfeiture options. To explain what the cash value is, know that the mortality rate increases with age, and individuals tend to select in and out of insurance groups depending upon the perceived benefits and costs.

With the various forms of cash value life insurance, the insurer allows the **policyowner** to pay level premiums. That is, the insurer allows the insured to overpay the mortality expense in the early years of the **contract** so the insured may underpay the mortality expense in the later years. The premium amount stays the same throughout. The policyowner does not experience an increasing premium that encourages the self-selection process. The cash value is therefore a sum owned by the policyowners to prefund the expected increase in mortality costs.

The premiums accumulate in the policy's cash value account, earning tax-deferred interest. The main purpose of the cash value is to help pay for future increasing insurance costs and keep premiums level so that an individual can budget for lifetime protection. Many people also use the cash value to draw on in times of financial need.

In universal life insurance policies, the insurer deducts the mortality costs from the cash value and credits the remainder of the cash value with interest each month. Lower mortality charges may be deducted from the cash value. The cash value of the policy may be available whenever needed to help pay monthly premiums or to borrow against the policy, but there can be drawbacks to borrowing from the cash value. A policyowner may have to pay interest, and if he or she dies while a loan is outstanding, the payments to the beneficiaries may be reduced by the amount of the loan outstanding.

In the first couple of years of a universal life **insurance policy**, the cash value is equal to zero because the insurance company deducts certain expenses. Over the life of the policy, there is a steady increase in the amount of the cash until the age of maturity (usually age 100), when the cash value is exactly equal to the policy's **face amount**.

Most universal life insurance policies guarantee a minimum interest rate of 4% or 4.5% on the cash value. If economic **conditions** warrant, the interest rate may be higher, but it can be no lower than the minimum stated in the contract. Insurers normally state that the current interest rate on the cash value will reflect current interest rates in the economy, but no lower than the stated minimum.

The cash value of a universal life insurance policy may be used as collateral for a policy loan in much the same way that the cash value of a traditional whole life policy may be used. The money in a universal life insurance policy's cash value may also be withdrawn, rather than used as collateral for a policy loan. In either case, the cash value is reduced by the amount withdrawn plus any applicable cash withdrawal fees,

but the policy remains in force. There are **policy limits** to withdrawal and loan amounts. In contrast, the owner of a traditional whole life insurance policy can withdraw the cash value only by canceling the policy.

## 1. Adjustments to the Cash Value Account

The cash accounts in a universal life **insurance policy** are subdivided into an accumulation account and a cash value account. The accumulation account reflects the total amount earned. The cash value account is the money that the **policyowner** can actually get. The cost of insurance (COI) increases as the consumer ages. If the universal life contract is underfunded (too few premiums), there will not be enough interest on the cash values to defray the increased COI. Furthermore, a well-funded universal life contract will require less COI on a long-term basis because of increasing cash values.

If premiums are insufficient on a long-term basis and the cash value falls to zero, the consumer is faced with the prospect of paying gigantic insurance premiums based upon current age. *For example*, an individual bought a universal life contract at age 30. Because of insufficient premiums, the policy cash value crashed to zero at age 90. The cost of the insurance at age 90 would probably be unaffordable. If a consumer could not afford the high premiums at this point, the coverage would **lapse**.

## 2. Borrowing

The policy will have cash value that can be borrowed from. Therefore, this money can be used as a savings account. The universal life insurance **contract** allows the **policyowner** to withdraw cash value amounts without paying interest. Most insurers charge a withdrawal fee that can be a flat amount, a percentage of the amount, or a combination. In the case of a loan, interest will be charged by the insurer and the amount borrowed continues to earn the guaranteed rate, and the remaining cash value earns the higher current rate.

The cash value of a universal life **insurance policy** may be used as collateral for a policy loan in much the same way that the cash value of a traditional whole life policy may be used. The amount of money that may be borrowed is the current cash value, less any outstanding and unpaid policy loans.

Universal life policies often do not require repayment of a policy loan. This is similar to rules of whole life policies. However, if the loan amount and interest due are not paid, the amounts will be deducted from the **death benefit** if the policyowner dies before the loan is repaid.

With some newer universal life policies, not only is interest charged on policy loans, but the owner also forgoes the "excess" interest credit. In general, an individual may not deduct the interest on policyowner loans.

## 3. Surrender Account

There are three nonforfeiture options in a universal life **insurance policy**. These options are required by law, and the privilege of using them at any time cannot be denied legally by an insurance company. They are an important part of a life insurance contract and should be thoroughly understood by every **policyowner**. One of the nonforfeiture options involves the termination of the policy, along with all the protection afforded by it. This is called **surrender**.

If a policyowner surrenders a policy and receives an amount in excess of his or her cost, the difference is subject to taxation in the year the surrender is made. However,

no tax loss arises if a policy is surrendered for less than the cost basis. The policyowner's cost basis in a life insurance policy is the total of all premiums and policy loan repayments paid into the policy less any amounts received from the policy (including loans).

Using the policyowner loan provision should always be considered as an alternative to surrender. The amount of cash generated will be the same in most instances, but using the loan provision leaves some death proceeds available for a while. If a policy is surrendered, it is a final act; all contractual rights end. Loans, or just the interest due, can be repaid, keeping the policy in force.

Surrender charges do not apply to options with lifetime income, or income for 10 years or more. If the policyowner dies before receiving benefits from the annuity proceeds, universal life insurance will usually waive the surrender charge if it would ordinarily apply at that time. When a spouse is the **beneficiary**, the annuity may continue or the funds may be disbursed.

#### 4. Withdrawals

The money in a universal life policy's cash value may also be withdrawn. The cash value is reduced by the amount withdrawn, plus any applicable cash withdrawal fees, but the policy remains in force. Each policy year, an individual may withdraw up to 10% of the accumulated value without a surrender charge. In most states, this 10% can be saved and combined with several unused 10% withdrawals for larger withdrawals in future years.

Some universal life policies have a **market value adjustment** (MVA) applied to withdrawals from or surrender of the policy during the surrender charge period. The market value adjustment can be positive or negative and is applied in addition to any surrender charge stated in the policy **contract**. While formulas vary from one company to another, generally the market value adjustment will be negative (meaning it will reduce the amount of withdrawal or surrender value available to the policyowner) when the prevailing interest rates at the time of withdrawal are lower than they were at time of contract issue.

Conversely, if prevailing interest rates at the time of withdrawal or surrender are higher than when the policy was issued, the market value adjustment will be a positive amount, and will increase the amount received from the policy. The market value adjustment does not apply to the 10% "free" withdrawals. In addition, MVA and surrender charges are usually waived upon death or when a **beneficiary** elects an income settlement option of 10 years or longer.

#### C. Policy Offset

A **policyowner** can withdraw available cash from a universal life policy, but this may be taxable, subject to applicable surrender charges and a \$25 fee. In future years, a policyowner may make withdrawals or take loans from the policy, depending on policy values, premium payment history, and exercise of any other options within limits stated in the policy. A policyowner can borrow against a policy at very favorable rates or withdraw available cash from the policy.

A popular option with universal life insurance is **offset**. With this option, the policyowner can elect to discontinue premium payments once the **contract** has sufficient cash value to keep it in force – essentially a paid-up contract. The policy will

remain "paid-up" only if the current interest and mortality levels are continued as was assumed until maturity (or are more favorable than assumed).

If not, the policyowner may have to pay premiums again in the future. In addition, "dump-ins" (unscheduled premium payments) may be made on a universal life [insurance policy](#), thereby increasing the cash value. This is an excellent vehicle to shelter extra money to which a [beneficiary](#) may become an heir. When evaluating a universal life insurance policy, an individual needs to take a close look at its interest rate track record, because the credited rates vary tremendously due to different investment philosophies. The interest crediting history should be evaluated; this will show how well the company responds to changes in the market.

Because universal life insurance policies are unbundled, it's fairly easy to compare sales loads and monthly charges, which vary from product to product. Another valuable comparison is to look at the products' past performances in terms of interest rates credited to the cash value. When examining all these elements, an individual will see the "whole picture" needed for a fair comparison. Universal life uses the low cost of term insurance and allows the [policyowner](#) the opportunity to share with the insurance company the risk/reward by adding a savings element that is credited with a rate of investment return based on a predetermined formula reflective of current economic trends.

Universal life insurance has fewer guaranteed elements. However, if an individual is interested in having the premium dollars perform "double duty," giving a more competitive tax-deferred investment return while providing life insurance coverage, universal life may be the answer.

## D. Grace Period Feature

The universal life insurance [contract](#) is legally "unilateral." Therefore, only one party to the contract, the insurer, must perform. However, the insurer must perform only if the [policyowner](#) pays the premium and abides by the [conditions](#) in the contract. When the insurer does not receive the premium payment by its due date, the policy then goes into the [grace period](#). There is a grace period of 31 days from the premium due date in which to make a premium payment.

If the premium is not received at the end of the grace period, the policy lapses or terminates if there is no cash value. During the grace period, coverage continues in force. This is to protect the beneficiaries if the policyowner happens to die during the grace period, because the [death benefit](#) remains payable. Any premium due to cover the grace period extension would be deducted from the final settlement.

The purpose of this provision is to protect the policyowner from unintentionally allowing the policy to lapse. Without this provision, if the payment was even one day late, benefits could be denied and the policyowner might have to furnish evidence of [insurability](#) to continue coverage. If the policy has cash value, the contract will continue under one of the nonforfeiture options.

According to the nonforfeiture options, a [policyowner](#) is allowed to

- Surrender the [contract](#) for cash;
- Borrow the cash value;
- Convert it to extended term insurance; or
- Convert it to paid-up permanent insurance.

A **grace period** of at least 7 days for weekly premium policies, 10 days for monthly premium policies, and 31 days for all other policies will be granted for the payment of each premium falling due after the first premium, during which the policy will continue in force. A policy that contains a **cancellation** provision may add, at the end of the above provision, "subject to the right of the insurer to cancel in accordance with the cancellation provision hereof."

Universal life can change as financial needs and goals change. *For example*, an individual is starting a family and has limited resources. Universal life's premium can be set low, providing the amount of coverage needed to protect loved ones at a very affordable cost. As circumstances change and responsibilities grow, the insurance amount may be increased, or premiums can be increased to help build the cash accumulation of a policy more rapidly. There is no need for a policyowner to weave in and out of life insurance replacements, trying to find the one that is just right for a different life situation.

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Quiz

## Universal Life Insurance and Taxes

### A. Modified Endowment Contracts (MECs) and Tax Reforms

Until the mid-1980s, insurance companies promoted life insurance policies like single premium life that emphasized cash accumulations, borrowing, and investment choices, rather than traditional death benefits. With single premium whole life policies, one single premium is paid up front to provide a guaranteed death benefit. The contract's guaranteed cash value grows on a tax-deferred basis. *For example*, a \$175,000 premium might purchase a \$500,000 death benefit, payable tax-free to beneficiaries upon the policyowner's death.

Prior to June 21, 1988, these policies combined the following:

- High returns;
- Tax deferral;
- Tax **avoidance** on those returns; and
- The ability to access those returns without current taxation.

The federal government decided that it was losing too much tax in certain contracts where the amount of the premium paid is considered excessive.

Policies purchased after 1988 are affected. The MECs' restrictions also apply to retirement income endowments and semi-endowments, where the amount payable upon survival of the endowment period is greater than the **face amount**, and the amount payable upon death is the greater of the face amount and cash value.

Modified endowment contracts (MECs) have some of the attractive tax benefits generally available to life insurance products. *For example*, both the accumulation of cash value and the benefits payable upon death are exempt from income tax. Policy withdrawals and loans, however, will generally be considered taxable distributions to the extent of taxable earnings accumulated in the policy. If one does not intend to make withdrawals from the policy, it may be more financially advantageous to purchase a single premium life **insurance policy**, even if it is classified as a MEC.

To discourage the purchase of life insurance as a tax-sheltered investment, Congress passed the Technical and Miscellaneous Revenue Act (TAMRA) in November 1988, which makes any withdrawal, loan, or collateralizing of the cash in a MEC taxable. This law defined a new class of life insurance policies that the government considered too investment-oriented, named modified endowment contracts (MECs), and removed the tax-free accessibility to the cash in these policies.

Any policy issued after June 20, 1988, that falls into the classification of a modified endowment contract cannot provide the **policyowner** with the privilege of

withdrawing from, borrowing from, or collateralizing the values accrued within the policy without incurring immediate taxation on policy gains that are withdrawn, borrowed, or collateralized.

If the policyowner is under age 59½, not only do income taxes become due on the amount of gain accessed in the contract, but also a 10% penalty would be applicable to the amount included in gross income as a result of the withdrawal, borrowing, or collateralization. Exceptions to this penalty are if the funds are withdrawn as a result of disability or over a life annuity period.

In order to avoid the taxation and subsequent penalties, the policyowner must limit investment according to the "7-pay test" established by the government, which limits the amount that may be paid into the policy during the first 7 policy years. If too much is paid in premiums over the first 7 years, or if the **face amount** of the policy is reduced, it may create a MEC and a tax liability will be incurred.

Following the passage of the Tax Reform Act of 1984, which eliminated many tax-shelter investments, the insurance industry launched an aggressive campaign to sell single premium variable life insurance as one of the few remaining legitimate tax sheltered investments.

Like an IRA, if the **policyowner** cashes it in early, he or she will be taxed on everything earned while inside the cover of the policy. Up until June 1988, a policyowner could get around that simply by borrowing against the policy. Congress moved to close that loophole retroactive to June 1988, when it passed a tax technical correction bill in October 1988. The tax bill eliminated the ability to take tax-free loans from single premium life policies purchased after June 21, 1988.

Money taken out before age 59½ is subject to a 10% penalty tax, as well as ordinary income tax on the gains. Single premium life insurance maintained other tax advantages, including tax-deferral on investment gains and tax-free payment of death benefits to beneficiaries. Life insurance proceeds represent a great deal of money, often the bulk of a policyowner's estate, so tax considerations become very important.

Generally, life insurance proceeds are received federal income tax-free if taken in a lump-sum death benefit. However, life insurance proceeds are included in the deceased's gross estate for federal estate tax purposes. If the insured person does not own the policy (if it has been assigned), then the proceeds would be included in the person's estate, thereby possibly reducing the federal estate tax liability. The policyowner must have an **insurable interest** in the insured person. Life insurance proceeds are also subject to inclusion in the deceased's estate for federal estate tax purposes if the estate was the named **beneficiary**.

Whether the life insurance proceeds actually will be taxed in accordance with federal estate tax laws will depend on the deceased's estate situation. There are deductions and exemptions that may be applied to adjust a person's estate for tax purposes. Other estate planning techniques, such as the use of trusts and gifts, can also reduce the size of a person's taxable estate. Regardless of the tax consequences, life insurance proceeds are included in the estate. In accordance with IRC section 1035(a), certain exchanges of insurance policies and annuities may occur as nontaxable exchanges.

Under IRC 1035(a), if a **policyowner** exchanges a life policy for another life policy with the same insured person and **beneficiary**, the income tax cost basis of the original policy is transferred to the new policy and no gain is recognized as a result of the

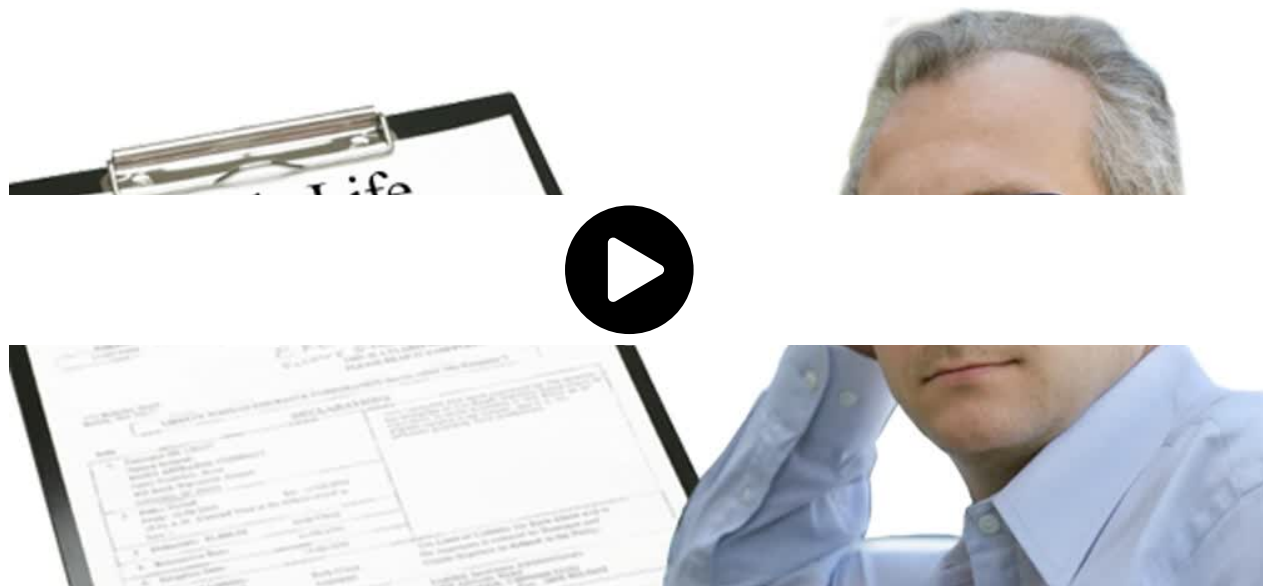
exchange. In effect, the gain that had accumulated in the original policy is transferred to the new life policy and will be taxed when distributed from the new policy.

The difference between life insurance taxation and annuity taxation is that a partial withdrawal from an annuity is considered a removal of interest first and is fully taxable as such. A tax-deferred fixed annuity is a **contract** with principal and interest that are backed by the insurance company issuing the contract. Plus, the accumulation value grows tax-deferred, sheltered from current taxation.

The cash value builds up tax-deferred, and policy loans can be taken out on a percentage of the cash-value balance without any tax consequences. If a policyowner surrenders the policy for its cash value, some of the cash value received may be subject to ordinary income tax if it exceeds the sum of the premiums paid for the policy. Also, when the insured dies, insurance proceeds are income tax-free and can be estate tax-free with proper planning and titling of the policy.

Life insurance can be used to pay estate taxes, fund deferred compensation agreements, and in some cases create wealth. The type of life insurance purchased depends on factors such as need, duration of need, and cost. Income tax considerations are also important and should be carefully evaluated in any life insurance transaction. Life insurance has two prominent tax attributes:

1. As a general rule, the increase in a policy's cash value is not taxable unless the cash value exceeds the income tax basis.
2. Proceeds paid by reason of the insured's death will generally be excluded from income.



## B. Taxation of Universal Life Insurance

When universal life was introduced in the early 1980s, the advances in computer technology allowed policies to be unbundled more easily. It was developed to overcome some of the disadvantages of term and whole life insurance. As with other

types of life insurance, the **policyowner** pays regular premiums to the insurance company in exchange for the insurance company paying a specific benefit to the heirs upon the death of the policyowner.

Universal life contracts separate the protection, expense, and cash value elements. A monthly charge for both the protection and expense elements is deducted from the policy's account balance. The remainder of the premium is allocated to the cash value element. Complete **disclosure** of internal charges against the cash value element is provided to the policyowners in the form of an annual statement.

In some situations, the combination of low term insurance rates, competitive yield on cash value, and tax benefits makes the universal life contract a viable approach to meet multiple needs.

## 1. Tax Basis

The income tax cost basis of a policy is the total premiums paid, including dividends used to purchase additional insurance, less any nontaxable distributions received.

## 2. Death Benefit

Although the **death benefit** is generally tax-free, there is an important exception that applies if an existing policy is sold to someone other than

- The insured;
- A partner of the insured;
- A partnership in which the insured is a partner; or
- A corporation in which the insured is a shareholder or officer.

If the owner of the policy sells an existing life policy to anyone other than listed above, the "transfer for value" exception applies and when the death benefit is paid, ordinary income is recognized to the extent that the death benefit exceeds the cost basis of the new owner.

## 3. Policy Dividends

Dividends paid, either distributed in cash or left in the policy to invest or purchase additional insurance, are considered a nontaxable return of capital until the amounts received exceed the cost basis in the policy. They are generally not taxable. Withdrawals in excess of cost basis are taxed as ordinary income. Policy loans are generally not taxable.

## 4. Interest on Policy Loans

The tax laws distinguish between single premium insurance (where all of the premiums are paid within 1 year from the purchase date) and insurance other than single premium. For policies with periodic premiums, no deduction for interest paid on a policy loan is allowed if the loan was incurred pursuant to a plan to borrow the increases in the policy's cash value.

## 5. Exchange

Generally, **no gain or loss** will be recognized in an exchange of policies if:

- It is a like-kind exchange;
- The insured remains the same; and
- No cash (including no reduction in debt) is received nor deemed to be receivable as part of the transaction.

Should there be a receipt of cash, including a reduction of debt, gain is recognized to the extent that there is a "profit" in the policy. After the exchange, the basis of the old policy becomes the basis of the new policy, subject to adjustments for debt reduction or cash received.

## C. Advantages and Disadvantages of Universal Life

Universal life insurance has a variety of advantages and disadvantages compared to other types of policies. It differs from whole life in that these policies distinguish and itemize the protection, expense, and cash value elements. The advantage of this separation is that the insurance company can build more flexibility into the policy. Let's look at some other advantages and disadvantages of universal insurance.

### 1. Advantages

- The policy is transparent. In other words, the policy illustrations and annual reports break out and report each of the policy elements separately. This unbundling of the policy allows the **policyowner** to specifically identify and track premiums, death benefits, interest credits, mortality charges, expenses, and cash values. It also allows the policyowner to check projections against actual performance over time.
- Universal life insurance policies historically have paid a higher effective rate of interest on cash values than tax-free municipal bonds. Rates credited to these policies have more closely tracked rates paid on high-grade corporate and government bonds and mortgages.
- The policyowner has wide flexibility in selecting the premiums that are paid. Provided that there is enough cash value to cover mortality charges, the policyowner may even skip premium payments.
- Most universal life insurance policies offer two death benefit patterns, Options A and B.
- The policyowner may change the level of death benefits. Decreases in the death benefit are permitted at virtually any time. Increases in **face amount** are generally permitted, subject to evidence of **insurability**.
- Policy cash values can be borrowed at a low net cost. Although policyowners must pay interest on policy loans, cash values continue to grow and are credited with at least the minimum guaranteed rate policy.
- Although the interest credited to cash values will vary with market rates, the cash values are not subject to the fluctuations in market value characteristic of longer-term municipal bonds and other longer-term fixed income investments when market rates change.

### 2. Disadvantages

- The flexibility with respect to premium payments and death benefits permits policyowners to change the policy in such a way that it may inadvertently become a modified endowment **contract** (MEC) with adverse tax consequences.
- Although traditional participating whole life policies are indirectly interest sensitive, mortality and expense charges are guaranteed. In a universal life policy, the policyowners bear more of the risk of adverse trends in mortality or expenses than if they owned traditional whole life policies.
- Some universal life insurance policies, similar to many traditional whole life policies, use what is called the direct recognition method to determine the amounts credited to cash values that are subject to policy loans. Under this method, only the portion of the cash value that is not used to secure a loan is credited with the current rate.
- Some newer and most older policies use a two-tiered interest crediting approach that credits interest on the first \$1,000 or so of cash value at the minimum rate guaranteed in the contract.
- Surrender of the policy within the first 10 years may result in considerable loss, because surrender values reflect the insurance company's recovery of sales commissions and initial policy expenses.

## D. Suitability

### 1. Appropriate Sales

Universal life insurance is best suited for individuals who want protection while leaving their payment options open. With universal life insurance, part of the premium covers the cost of insurance, and the rest becomes part of the cash value of the policy.

Most universal life insurance policies have optional term riders that can be used to increase the **death benefit** without purchasing a new policy.

Interest credited can be kept in the cash value of the policy until death, at which time they will only be subject to estate taxes. The cash value can be accessed before death via a policy loan that is tax-free and does not require surrender of the policy.

Universal life allows the policyholder to, within limits, determine when to make payments and how much to pay. If a long period goes by without a premium payment, the cost of insurance is deducted from the cash value of the policy.

### 2. Suitability Checklist

*What are your primary objectives in obtaining life insurance coverage?*

- \_\_\_\_\_ Asset preservation
- \_\_\_\_\_ Debt protection
- \_\_\_\_\_ Death benefit for heirs (liquidity for taxes)
- \_\_\_\_\_ Funeral expenses
- \_\_\_\_\_ Income replacement (major wage earner)
- \_\_\_\_\_ Business continuity
- \_\_\_\_\_ Charitable gifting
- \_\_\_\_\_ Retirement supplement

*Which of the following statements best summarize your financial objectives?*

- \_\_\_\_\_ My goal is to pay a low premium and have **death benefit** protection for a limited time.
- \_\_\_\_\_ I want death benefit protection and access to cash values for life.
- \_\_\_\_\_ I want to be able to access cash values in the future.
- \_\_\_\_\_ I want death benefit and premium guarantees.
- \_\_\_\_\_ I plan to keep this policy in force for at least 15 years.
- \_\_\_\_\_ I am concerned about inflation and want to take steps to reduce its impact on my future finances.
- \_\_\_\_\_ It is important for me to be able to change the underlying investments in my policy.
- \_\_\_\_\_ It is important for me to be able to increase or decrease the policy death benefit.
- \_\_\_\_\_ It is important for me to have some flexibility in premium payment amounts.
- \_\_\_\_\_ I am comfortable with some risk to principal because it offers the best potential for long-term results.

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## Variable Life Insurance

Variable life insurance is a form of cash value life insurance that uses separate accounts for cash value accumulation. The term “separate account” simply means that the account(s) where the cash value is invested are separate from the insurance company general account. The value of the death benefits may fluctuate depending on the performance of the separate accounts where the cash values are invested.

**NOTE:** The separate accounts are often called **subaccounts**.

Although most variable life insurance policies guarantee that the death benefit will not fall below a specified minimum, a minimum cash value is seldom guaranteed. While variable life is a form of whole life insurance, because of investment risks, it is classified as a security **contract** and is regulated under federal securities laws.

Variable life offers the potential for a greater return on cash values than other forms of cash value insurance. While there is a potential for a greater return, it is important to keep in mind that if one wants the benefits of higher investment returns, one must also be willing to assume the risks of loss. Bigger investment profits in the subaccounts can lead to an increased death benefit and an accelerated build-up in cash value. However, investments can also end up losing money (sometimes in a big way), and that can lead to lower cash values and reduced insurance coverage, although it can never fall below the minimum death benefit stated in the policy.

A variable life **insurance policy** offers a fixed premium and a minimum death benefit.

### A. Definition of Variable Life Insurance

Variable life insurance is cash-value life insurance with values reflecting the performance of a variety of funds (subaccounts) that the **policyowner** has selected. It differs from traditional cash value life insurance where the insurance company invests the cash value in investments with relatively predictable performance over long periods.

With variable life insurance, one chooses how the cash value is invested among a variety of funds, such as growth, value, index, balanced, overseas, money market funds, and often a fixed account. There is no limit on the potential growth of cash value. This means that over time, both the cash value and the **death benefit** have the opportunity to outperform other forms of life insurance. Unlike traditional life insurance, variable life insurance has inherent risks associated with it, including **exposure** of the death benefit and cash value to market volatility.

Variable life insurance is patterned after the variable annuity, which had been available for a number of years before variable life insurance was introduced, and was designed

as a solution to the decline in purchasing power of the dollar due to inflation.

Although several models were proposed for a variable life policy, the plan that eventually emerged is patterned after the **ratio plan**, under which the premium is fixed but the **face amount** of the policy varies, subject to a minimum that is the original amount of insurance. The cash value of the policy is not guaranteed and fluctuates with the performance of the portfolio in which the premiums have been invested.

It varies by insurer and policy, but most often the policyowner decides how to invest the cash value portion of the account.

Although the NAIC approved model legislation providing for the sale of variable life policies in 1969 and recommended this legislation to the states, there remained the problem of the equity-based nature of the **contract** and the qualification requirements of the Securities and Exchange Commission (SEC). In 1972, seeking to avoid the difficulties encountered in connection with variable annuities, the insurance industry petitioned the SEC for exemption on variable life. The SEC ruled that variable life would be treated as a security, which meant that such contracts only could be sold by agents registered as broker/dealers with the Financial Industry Regulatory Authority (FINRA).

## B. Features and Benefits of Variable Life Insurance

Variable life policies carry many of the features of universal life, with the added distinction that death benefits and premiums are more directly linked to the performance of investments, and policyowners have a say in how their funds are invested. Here are some of its distinct features.

An individual can select a level death benefit or choose a death benefit that increases as the cash value grows. Guarantees are based on the claims-paying ability of the insurance company and do not extend to the variable subaccounts, which may fluctuate with market or other economic **conditions**.

### 1. Enhanced Policy Loan

The enhanced policy loan feature lets one borrow from his or her cash value (at zero net interest cost) when specific cash values are achieved or when the policy has been in force for a specific length of time.

### 2. Regular Policy Loan

The regular policy loan allows one to borrow from a cash value at 2.5% net interest cost. Some variable life insurance policies offer up to 30 different subaccounts in which the **policyowner** can allocate their cash values. The policyowner does have access to their cash value accumulations. An individual can withdraw accumulations or arrange tax-free loans against the policy. Loans and withdrawals reduce the cash value of the policy and the **death benefit**.

### 3. Adjustable Premiums

An individual needs to decide how much premium to pay and when to pay it based on the performance of his or her subaccounts and changing needs.

### 4. Tax Advantage Liquidity

While policyowners do have access to their cash values through loans, and these loans or not considered taxable income, loans and withdrawals will reduce the amount of the policy's cash values and **death benefit**, and withdrawals may be taxable.

## 5. Variable Savings Feature

The savings portion is not tied to a fixed-income investment. The cash buildup is dependent on the performance of the subaccounts, which can contain stocks or bonds, typically through mutual funds.

## 6. Death Benefit Choices

The **policyowner** can select Option A for a level **death benefit** or Option B for a death benefit that increases if the cash value grows.

- **Option A: Level Guaranteed Death Benefit** — The level death benefit guarantees the policyowner that the policy will not **lapse** for any reason, regardless of investment performance, as long as one pays his or her minimum premium stated in the **contract**. The death benefit is equal to the **face amount** of coverage purchased less outstanding policy loans only. As cash values grow, they reduce the net amount of death benefit risk to the insurer and thereby reduce the mortality expense charges deducted from the subaccount. Increases in cash value do not increase the death benefit above the original amount of coverage purchased.
- **Option B: Variable Death Benefit** — The variable death benefit guarantees the policyowner that the policy will not lapse for any reason, regardless of investment performance, as long as one pays his or her minimum premium stated in the contract. The death benefit is equal to the face amount purchased less any policy loans, plus the accumulated cash value. As cash values grow, they do not reduce the net amount of death benefit risk the insurer is exposed to and thereby do not reduce the mortality expense charges deducted from the subaccounts.

A variable life insurance death benefit, like other life insurance types, passes income tax free to the beneficiary.

## 7. Waiver of Monthly Deduction Benefit

The waiver of monthly deduction benefit waives monthly deductions for the cost of insurance and policy fees if the **policyowner** is disabled. This affords the same protection to the policyowner that a waiver of premium does for other policies.

Variable life policies have the potential for greater and quicker cash value accumulations than other standard life insurance policies, but they require more attention and participation on the part of the owner to manage the allocation of cash values among the subaccount choices.

**The policyowner of a variable life product is assuming the entire investment risk.**

## C. Variable Life Insurance Riders

### 1. Accelerated Benefit Rider

The accelerated benefit **rider** provides early access to the **death benefit** if the insured becomes terminally ill.

### 2. Primary Insured Rider

A primary insured **rider** provides policyowners with additional term insurance on the primary insured with guaranteed convertibility.

### 3. Additional Insured Rider

The additional insured **rider** provides additional term insurance for up to five family members. It permits coverage of nonfamily members for business reasons.

### 4. Children's Term Rider

The **children's term rider** allows children of the insured (natural, adopted or stepchildren) to be added to coverage for a limited period of time for a specified amount. This coverage is also term insurance and usually expires when the minor reaches a certain age (18 or 21). Most riders provide the minor with the option of converting to a permanent policy without evidence of **insurability**.

## D. Expense Factors of Variable Life Insurance Products

Expense factors have to do with various variable policy features. Some variable policies do not contain all of these expense factors, but all variable policies contain some of them. All expenses will be disclosed in the policy prospectus.

### 1. Issue Expense

Sales commissions and other front end costs to issue a variable policy, which may run between \$2.50 and \$10 per \$1,000 of **face amount**, are deducted from the policy. Some policies take this expense directly from the first year's premium. Other companies total these costs and express them as a "contingent deferred sales charge," which is only charged against the policy of the policy owner surrenders the policy before a certain number of years.

### 2. Sales Load

The variable insurance salesman earns whole life commissions, generally 50%–60% of the premium in the first year, plus another 60%–70% over the next 9 years. This does not include field management commissions, overrides, and various "allowances" based on the agent's sales volume. The maximum sales load allowed by law is 9% of the premium over 20 years.

So if an individual pays \$1,000 in premiums, the maximum permitted sales charge over 20 years is 9% of \$20,000, or \$1,800. The salesman and managers will not wait 20 years for their commissions. To pay them, the company reaches into its surplus account, hoping that the policy will stay in force long enough to repay the "loan" to finance sales. If the company is a mutual company (or is owned by one), the surplus account is the policyowners' money that was not paid as dividends but retained by the company on the excuse that this surplus would "improve policyowner security."

### 3. Mortality Charge

Mortality charges are the "premiums" withdrawn from the policy's investment account to pay for term insurance inside the policy. The maximum mortality charges guaranteed by the policy are very conservative.

### 4. Surrender Penalties

It is not a matter of whether a variable **insurance policy** is subject to surrender charges. The important determination is how much those surrender charges are and how they are assessed. The amounts and procedures vary widely between companies and policies, but will be detailed in the prospectus.

### 5. Policy Fee

It is customary and almost uniform in the industry to determine the total premium by multiplying a basic rate by the number of thousands and then adding a fixed policy fee that is generally about \$50. Theoretically, the policy fee is to cover the administrative cost to the insurance company for the policy. The effect is to provide a lower rate per thousand for customers who can afford larger policies. Because the policy fee is part of the premium, the **policyowner** pays it every year.

## 6. Risk Charges

Some variable policies guarantee to pay the original **death benefit**, even if the policy's investment account has dwindled to zero. For this generous feature, the company charges a separate premium called the **risk charge**, which can run between 1% and 3% of every premium the **policyowner** pays.

## 7. Mortality and Expense Risk Charges

**Mortality risk** is not to be confused with either the "risk charge" or the "mortality charge." The mortality risk assumes that insureds may live for a shorter period of time than estimated. Therefore, a greater amount of **death benefit** than expected will be payable compared to the amount of premiums received. The expense risk assumes that expenses incurred in issuing and administering the policies will be greater than estimated. The insurance company will then realize a gain from this charge to the extent that it is not needed to provide for benefits and expenses. This charge for some insurance companies is 0.5% per year against the policyowner's investment account. The charge is deducted daily.

## 8. Dividend Reduction

Not every variable policy pays dividends. In fact, participating variable policies are something of a rarity. However, the prospectus for one insurance company states that "a deduction for dividends to be paid or credited" will be made from premiums and that "this deduction will vary, but is expected to average 8–13% of the basic annual premium."

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## Types of Variable Life Insurance and Other Related Concepts

### A. Variable Whole Life Insurance

In addition to a guaranteed level fixed premium and a guaranteed [death benefit](#), variable whole life offers a variety of investment choices:

- Benefits;
- Tax advantages;
- Features; and
- Tax-free transfers between funds.

One may choose the death benefit option and the premium level, subject to underwriting guidelines and company qualifications. A policy is guaranteed to stay in force provided that one pays the required premium when it is due; the death benefit will never be less than the [face amount](#) (reduced by any outstanding loans). Usually, the [policyowner](#) may change the asset allocation of the cash value up to 12 times per year.

### B. Variable Second-to-Die Life Insurance

A variable second-to-die life [insurance policy](#) allows the [policyowner](#) to control the composition and diversification of investments within the policy. There are up to 30 investment choices within some second-to-die insurance variable policies and tax-free transfers within investment subaccounts.

A variable second-to-die life insurance policy has access to tax-deferred cash value accumulations. One can withdraw accumulations or arrange tax-free loans against the policy. Loans and withdrawals reduce the cash value of the policy and the [death benefit](#). Income tax-free survivor benefits in a variable second-to-die life insurance policy are payable upon death of the second party.

A medical physical examination is required for issuance. Policies on two lives are available for one healthy person, even if other person is unhealthy. The annual cost can be paid by the insured, beneficiaries, or others. Sometimes policies are held in irrevocable life insurance trusts to move the [face amount](#) of the death benefit out of the estate of the deceased. The following are some other features:

- Available for individual or corporate purchasers;
- Cash value component of other life insurance policies can transfer into single premium variable life insurance policies;
- Medical physical required for issuance;
- Income tax-free survivor benefits;
- Most have no-cost switches between investment subsets; and
- Some offer no-cost daily switches.

Major asset investment categories are available within investment subsets, such as growth, growth and income, balanced, U.S. government and corporate bonds, U.S. government zero-coupon bonds, foreign bonds, high-yield bonds, large capitalization stocks, small capitalization stocks, and index funds.

Some issuing insurance companies offer the same investment choices within their flexible premium variable life, second-to-die variable life, and single premium life insurance policies.

## C. Single Premium Variable Life Insurance

Single premium variable life insurance is generally not tax **deductible**, has tax-deferred growth, and is a tax-free distribution policy. To a certain extent, variable life insurance policies offer a **death benefit** and a future cash value component based on the rate of return performance of the investment choices selected by the client. It is an **insurance policy** that allows one to control the amount of life insurance protection, as well as composition and diversification of the investments within the policy. A single premium variable life insurance policy allows one to control the premium payment and access to funds.

## D. The Workings of Variable Life Insurance

The major difference between the investment portion of variable life and other forms of life insurance is that the insured may select how the funds in the investment portion of the policy are invested. The insured may invest in an array of investment vehicles, such as stocks, bonds, or mutual funds. The catch is that one may only choose from investment vehicles from his or her insurance company's portfolio. Some insurance companies allow a **policyowner** to select investment vehicles managed by other companies.

Some variable life policies allow one to place monies into money market, limited term bond, or fixed rate accounts, then periodically and systematically take the earned interest from these accounts and invest into other choices within the investment subaccounts.

Some variable life policies offer a program in which the investment is split between the fixed and variable accounts. At the end of the term selected, the fixed account grows to the original investment. The variable component of the investment will reflect the growth (if any) of the cash values.

Variable life policies are regulated securities and regulated by both federal and state regulators. Each offered variable life policy is specific to the state in which it is offered. Consequently, the terms and **conditions** of a **contract** offered in one state might not be the same as in a different state.

## E. Variable Life Insurance and Taxes

Variable life blends the protection and tax advantages of modified single premium variable life insurance with choice of a range of tax-deferred investments. Together, these two elements offer a way to

- Help accumulate assets tax-deferred;
- Access those assets, should they be needed; and
- Pass those assets to beneficiaries free of federal and state income taxes.

## 1. Premium Tax

Virtually every state taxes life insurance premiums, commonly at a rate of 2% (though some may fall anywhere between 2% and 3%). In traditional life insurance policies, the company takes this tax into account when determining premiums and does not separately disclose the fact that the state premium taxes are paid. In variable policies, due to the **disclosure** requirements of securities, the premium tax is disclosed when charged.

The following chart compares and contrasts several characteristics of whole life, universal life, and variable life insurance policies:

Whole Life	Universal Life	Variable Life
<b>Death Benefit (DB):</b>		
Fixed/Guaranteed	May or may not provide a fixed DB	Fixed minimum DB
<b>Cash Value (CV):</b>		
Guaranteed	Guarantees a minimum interest rate	No guarantees
<b>Loans:</b>		
Allowed against the <i>entire</i> current CV	Allowed against the <i>entire</i> current CV	Allowed against a <i>percentage</i> of CV
<b>Premium Payment:</b>		
Generally paid in fixed amounts at fixed intervals	Flexible in amount and timing	Generally paid in fixed amounts at fixed intervals
<b>Investment Account</b>		
Assets in the <i>general account</i> of the insurance company	Assets in the <i>general account</i> of the insurance company	Policyowners can select a <i>separate account</i> that meets their investment objectives
<b>Risk to Cash Value</b>		
<i>Insurer</i> assumes investment risk	<i>Insurer</i> assumes investment risk	<i>Policyowner</i> assumes investment risk

## F. Advantages and Disadvantages of Variable Life Insurance

### Advantages:

- The **policyowner** can borrow cash from the policy during his or her lifetime.
- Variable life insurance provides some measure of automatic increases in death benefits that may keep pace with inflation. Death benefits are connected to changes in the underlying value of the assets that are backing the policy. Because the rate of return assumed when setting the guaranteed minimum death benefit is relatively low, death benefits generally should trend upward and provide some measure of inflation protection.
- Switches or transfers between funds are permitted at least once and usually more times per year, usually with no charge. Earnings on the assets underneath the policy cash values will accumulate tax-free or tax-deferred, depending on whether the gains are distributed at death or during the lifetime.

- Variable life insurance is a cash value policy designed to protect a policyowner and the beneficiaries from erosion of death benefit purchasing power due to inflation.

### Disadvantages:

- There is no premium or **face amount** flexibility in a variable life policy.
- Variable life insurance is expensive. Commissions and service fees can amount to a considerable sum, leaving less available to invest.
- Lifetime distributions or withdrawals of cash values are subject to income tax to the extent attributable to gain in the policy.
- Policyowners bear some mortality and expense risks because these policies are current-assumption policies with respect to mortality and expenses.
- The value of the death benefits may fluctuate, depending on the performance of the investment portion of the policy. However, the death benefit can never fall below a defined level.

## G. Suitability

### 1. Appropriate Sales

Variable life insurance is most appropriately sold to people who have a high risk tolerance for investments, because this policy combines death protection with investments in stocks, bonds, and money market mutual funds. Policy values may grow more quickly than with whole life insurance, but the **policyowner** also assumes more risk. If investments do not perform well, both the cash value and **death benefit** may decrease.

### 2. Suitability Checklist

*What are your primary objectives in obtaining life insurance coverage?*

- \_\_\_\_\_ Asset preservation
- \_\_\_\_\_ Debt protection
- \_\_\_\_\_ Death benefit for heirs (liquidity for taxes)
- \_\_\_\_\_ Funeral expenses
- \_\_\_\_\_ Income replacement (major wage earner)
- \_\_\_\_\_ Business continuity
- \_\_\_\_\_ Charitable gifting
- \_\_\_\_\_ Retirement supplement

*Which of the following statements best summarize your financial objectives?*

- \_\_\_\_\_ My goal is to pay a low premium and have **death benefit** protection for a limited time.
- \_\_\_\_\_ I want death benefit protection and access to cash values for life.
- \_\_\_\_\_ I want to be able to access cash values in the future.
- \_\_\_\_\_ I want death benefit and premium guarantees.
- \_\_\_\_\_ I plan to keep this policy in force for at least 15 years.
- \_\_\_\_\_ I am concerned about inflation and want to take steps to reduce its impact on my future finances.
- \_\_\_\_\_ It is important for me to be able to change the underlying investments in my policy.
- \_\_\_\_\_ It is important for me to be able to increase or decrease the policy death benefit.
- \_\_\_\_\_ It is important for me to have some flexibility in premium payment amounts.
- \_\_\_\_\_ I am comfortable with some risk to principal because it offers the best potential for long-term results.

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## Variable Universal Life Insurance

Variable universal life insurance is a product with many of the attributes of both variable life and universal life. Like variable life, the **policyowner** can allocate the investment of cash values among the subaccounts in the **contract**.

Like universal life, the policyowner has several **death benefit** options to choose from. The cash value of the policy will fluctuate based on the performance of the selected subaccounts and, depending on the death benefit option chosen, the death benefit may fluctuate as well. Taxation of variable universal life is the same as variable life including the potential for the product to be classified as a modified endowment contract and experience adverse tax consequences.

### A. Definition of Variable Universal Life Insurance

Since variable universal life insurance allows the cash values to be invested in securities products, it is regulated by both federal and state securities laws as well as state insurance laws. Agents must hold both insurance and securities licenses to sell the product and a prospectus must accompany each solicitation.

### B. Features and Benefits of Variable Universal Life Insurance

A variable universal life insurance **contract** combines features of variable and universal contracts. The insured's cash value account varies based on the performance of the underlying investments within the subaccounts, and the insured can adjust the premium amount or face value of the contract. Subaccounts options typically include stocks, bonds, balanced, or money market accounts. There is also usually a fixed account with a minimum guaranteed rate of return.

#### 1. Guaranteed Death Benefit

Under **death benefit** Option A, the variable universal life policy guarantees that as long as the minimum monthly premiums are paid, regardless of investment performance, the policy remains in force with the death benefit guaranteed to be no less than the **face amount** chosen at time of policy issue or the current face amount if the **policyowner** adjusted the face amount subsequent to policy issue. Death benefit Option A pays only the face amount of the coverage purchased and does not pay cash values in addition to the policy face amount.

Under death benefit Option B, the variable universal life policy guarantees that as long as the minimum monthly premiums are paid, regardless of investment performance, the policy remains in force with the death benefit guaranteed to be no less than the face amount chosen at time of policy issue or the current face amount if the policyowner adjusted the face amount subsequent to policy issue. Death benefit

Option B pays the face amount of the coverage purchased plus the accumulated cash value. Many variable universal policies also offer a third death benefit (usually called Option C).

Option C varies from company to company but the most common is illustrated below:

Typical death benefit Option C: Death benefit equals face amount of the policy plus all premiums paid into policy, less any policy loans or partial withdrawals. This death benefit option is sometimes called “return of premium.”

## 2. Multiple Liquidity Benefit

Variable universal life insurance offers access to the cash values in an individual's policy. This access includes the following:

- Loans for retirement with no net interest charge;
- Partial withdrawals of cash values, subject to a minimum withdrawal amount and a partial withdrawal charge;
- Regular policy loans at a low net interest charge; and
- Surrender of the policy at any time, subject to a declining and eventually disappearing surrender charge.

## 3. Flexible Premium Feature

After the first policy year most VUL contracts allow the [policyowner](#) to increase or decrease the premium payments, make payments more or less frequently, skip payments, or discontinue payments for periods of time (provided that the policy's cash value is sufficient to cover continuing policy charges).

This adjustable premium feature necessitates that a report must be sent to the policyowner whenever total charges authorized by the policy that are necessary to keep it in force exceed the amounts available within the policy to pay such charges.

## 4. Level or Adjustable Premium

As discussed earlier, the [policyowner](#) of a VUL policy has a fair amount of latitude over how much and when premiums are paid. However, the amount of premiums paid is subject to minimum premiums necessary to support the policy [face amount](#). In addition, premiums are subject to maximums. In order to prevent a VUL [contract](#) from being taxed as a modified endowment contract, insurance companies use one of two different tests that are considered safe harbors. These two tests are the cash value accumulation test (CVAT) and the guideline premium test (GPT). The average policyowner does not have the ability to monitor the policy under either of these tests so the insurers routinely test policies to ensure compliance.

## 5. Investment Selection Option

Most variable universal life policies offer several subaccounts for the [policyowner](#) to allocate among. The policy owner is usually allowed a fixed number of re-allocations per year without an additional charge. Often the allocations are limited to a minimum dollar or percentage, such as a minimum of \$2,500 or 10% of cash values to each subaccount.

## 6. Payment of Policy Proceeds Feature

Variable universal life offers several [death benefit settlement options](#), such as a lump sum death benefit, payments for a fixed period, payments for a minimum fixed period or life (whichever is longer), fixed amount payments with interest accruing, joint and

survivor lifetime income, payments of interest only with the remainder to a specified beneficiary, or installment refund.

## 7. Customized Policy Design Feature

Within the limits of the policy, a **policyowner** can customize variable universal life to fit their needs and adjust the policy as their needs change.

## 8. Fixed Value Account Feature

Many variable universal life policies offer a fixed value subaccount where a minimum interest rate and safety of principal is guaranteed. This fixed value or fixed rate account can be utilized by the **policyowner** to segregate some of the cash values into a guaranteed environment.

## 9. Tax-free Access and Transfers

With life insurance, increases in cash values resulting from investment income are not taxable as long as the policy remains "in force." If a policy is surrendered, the amount received, including any existing policy loans, is taxable as ordinary income to the extent of gain in the policy (if any). Cash withdrawals from such policies generally are taxed only to the extent that a withdrawal exceeds investment in the policy, and policy loans generally are not treated as taxable distributions. However, withdrawals during the first 15 policy years that result in a reduction in death benefits can trigger income taxation of gain.

## 10. Borrowing

Loans can be made against the accumulated cash value of a VUL policy; however, this is not without risk to the viability of the **contract**. Accessing cash values through a loan may significantly affect current and future contract values or death benefits. Many VUL policies include a "no **lapse** guarantee" which is benchmarked to establishing and maintaining certain minimum account values. The minimum account value is negatively impacted by policy loans, so the act of taking a loan (depending on the loan amount and the contract value immediately prior to the loan) could void the no lapse guarantee.

## 11. Liquidity Features

Several liquidity features unique to the variable annuity make penalty-free withdrawals available for certain unexpected life events:

- Involuntary unemployment;
- Total disability;
- Terminal illness;
- Nursing home confinement; and
- Divorce.

**Policy loans** are available at an attractive interest rate at any time after the first policy year. Beginning in the 11th policy year, loans are available at zero net cost. A **withdrawal (partial surrender)** up to 10% of policy value is often available after the first year without triggering surrender charges or a withdrawal fee. A **portion of death benefit** is available if one is diagnosed with a terminal illness and has a life expectancy of less than 12 months. The policy may be **surrendered** at any time for its accumulated value. Charges and penalties may apply. Investors may also have to pay income taxes and tax penalties on any money withdrawn.

*Note that these liquidity features may not be available in all states.*

## 12. Flexible Coverage

Most insurers require a minimum **face amount** of at least \$50,000 of coverage to issue a VUL policy. Once the policy is issued, the **death benefit** can be adjusted up or down but cannot be reduced below the minimum required face amount for policy issue. Proof of **insurability** may be required for face amount increases, rates are almost always attained age, and increases or decreases in the face amount are usually required to be in increments of \$10,000.

### C. Consumer Application

A 50-year-old fashion designer married a 55-year-old wealthy department store chain owner. An unfortunate skiing **accident** took the storeowner's life just after he retired and his wife inherited his estate. Now aged 52, the woman wants to preserve her estate for her children and cover her inevitable estate taxes, at least until she retires completely at age 70. In addition, she wants tax-deferred growth and to be able to borrow or withdraw funds to pay for potential business expansion opportunities. Having just settled her husband's estate, she has a lump sum available to fund this purchase. Because her business operations take so much of her time, she does not want any more bills to pay. She is bullish on the economy and considers herself to be an aggressive investor.

In this situation, variable universal life is an option because it

- Allows a lump-sum premium payment;
- Can guarantee coverage to age 70;
- Allows tax-deferred cash accumulation;
- Allows additional payments to increase cash values;
- Offers liquidity in the form of withdrawals and loans; and
- Has a choice of investments that can potentially increase the cash value.

### D. Advantages and Disadvantages of Variable Universal Life Insurance

Variable universal life insurance has advantages and disadvantages for individual policies, as well as business insurance. It can be used to provide potentially higher tax-deferred cash value accumulations in nonqualified deferred compensation plans than traditional policies or even universal life insurance.

On the other side, there are more investment risks involved with variable universal life insurance. If the investment performance is poor, the **policyowner** may be required to pay additional premiums to maintain the **face amount** of coverage.

#### 1. Advantages

- Variable universal life enables one to make withdrawals or borrow from the policy during his or her lifetime, and it offers separate accounts in which to invest.
- By contributing at regular intervals through dollar-cost averaging, a **policyowner** may get a lower overall cost on the units in which he or she is investing, without having to time the financial markets.
- The policyowner is never locked into an investment choice. The policyowner can also secure any gains made by transferring them into the cash management portfolio, or the fixed account on a limited basis. Those earnings can then remain there tax-deferred.
- A variable universal life policy provides **death benefit** assurances that the policy will continue in force for the guaranteed period, no matter what the investment performance of the subaccounts may be, as long as the required premiums are paid.

- When a disability benefit **rider** is added, it makes the minimum premium payments into the policy after the insured has been totally disabled for 6 months, which keeps the policy in force, including the insurance and investment components.

## 2. Disadvantages

- It requires the policyholder to devote time in managing the policy's accounts. The policy's success depends on the investments made.
- Premiums must be high enough to cover insurance and provide for cash value accumulation. It doesn't work well with small premium amounts because the premium must cover insurance and accounts.
- Loans and withdrawals will reduce a policy's cash value and **death benefit**. Depending upon the performance of the underlying investment options, the cash value available for loans and withdrawals may be worth more or less than the original amount invested in the policy. There may be substantial penalties and fees associated with policy loans and withdrawals. Always refer to the policy prospectus for an explanation of policy provisions, costs, expenses, and risks.

## E. Suitability

### 1. Appropriate Sales

Variable universal life combines the investment risks and rewards of variable life insurance with the ability to adjust premiums and **death benefit**. This type of policy is appropriate for individuals who need flexibility in premium obligations, have a long investment time horizon, and can tolerate the higher amount of risk in the separate account. If the investments in the separate account outperform those of the insurer's general account, there will be a greater financial return than would be received on a whole life policy with the same premium. There are tax advantages, especially for high-earning individuals in the higher income tax brackets. However, these policies are complex and require a significant premium outlay in order to perform well, so they are not appropriate for everyone.

### 2. Suitability Checklist

*What are your primary objectives in obtaining life insurance coverage?*

- \_\_\_\_\_ Asset preservation
- \_\_\_\_\_ Debt protection
- \_\_\_\_\_ Death benefit for heirs (liquidity for taxes)
- \_\_\_\_\_ Funeral expenses
- \_\_\_\_\_ Income replacement (major wage earner)
- \_\_\_\_\_ Business continuity
- \_\_\_\_\_ Charitable gifting
- \_\_\_\_\_ Retirement supplement

*Which of the following statements best summarize your financial objectives?*

- \_\_\_\_\_ My goal is to pay a low premium and have **death benefit** protection for a limited time.
- \_\_\_\_\_ I want death benefit protection and access to cash values for life.
- \_\_\_\_\_ I want to be able to access cash values in the future.
- \_\_\_\_\_ I want death benefit and premium guarantees.
- \_\_\_\_\_ I plan to keep this policy in force for at least 15 years.
- \_\_\_\_\_ I am concerned about inflation and want to take steps to reduce its impact on my future finances.
- \_\_\_\_\_ It is important for me to be able to change the underlying investments in my

policy.

\_\_\_\_\_ It is important for me to be able to increase or decrease the policy death benefit.

\_\_\_\_\_ It is important for me to have some flexibility in premium payment amounts.

\_\_\_\_\_ I am comfortable with some risk to principal because it offers the best potential for long-term results.

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## Group Life Insurance

Employer provided group life insurance is usually annual renewable term life insurance. This means that the coverage expires at the end of each year but is renewed automatically without a medical examination or evidence of **insurability**. The premium rate per \$1,000 of protection increases from year to year. Death benefits are paid upon the insured's death from any cause. The most common employer provided group life insurance benefit is coverage up to \$50,000 per employee of group term life insurance with **additional coverage** for the employee's spouse and dependents of up to \$2,000 each. The reason this is the most common employer provided group life benefit is because this is the amount and type of life insurance coverage that an employer can offer to their employees without the premiums paid being considered as income to the employee. Section 79 of the internal revenue code sets these limits. With this type of arrangement, the employer pays the policy premiums, deducts them as a business expense, does not add the premiums to the employee's W2, and the **death benefit** is still income tax free to the beneficiary.

Group term life **insurance policy** contracts usually contain a waiver of premium provision to protect both the disabled employee and the employer. A waiver of premium provision relieves the employer of the requirement to pay premiums for any covered employee who becomes totally and continuously disabled prior to a specified age in the policy contract. This age may vary but is commonly set at 60 years of age. This provides for the disabled employee to have life insurance coverage without the employee or employer having to continue premium payments.

### A. Defining Group Life Insurance

**Group insurance** refers to a variety of insurance products available to people who belong to a definable group. Group insurance can include life, disability, and health coverages. Group life insurance provides insurance for a group, typically 10 or more employees, under a master **contract** between the insurer and the group administrator (often the employer). Technically, the insured individuals are not part of that contract. Planners should note that almost 40% of all life insurance in force in the U.S. is group insurance.

Because life insurance is usually considered a basic workforce benefit, many employers offer it to their employees on a partially or fully subsidized basis. This means that the employer pays some or all of the premiums, so that the employee is covered at no cost or for much less than an individual policy. Group life plans enable employers and associations to provide life insurance protection for employees or members and their dependents.

### B. Types of Group Life Insurance

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Communication Workers of America, or any other organized labor or workers' union.

**Employer-Employee Groups:** Employer-employee groups are probably the most familiar type of group insurance. Under this arrangement, the employer makes insurance available to its employees.

**Creditor-Debtor Groups:** Creditor-debtor groups are formed when a lending institution offers the borrower or debtor the opportunity to purchase insurance coverage. This could be to protect the creditor by making funds available to pay off the loan if the debtor dies while the loan is outstanding. This is considered to be an eligible group life insurance plan because it is available to a group of people who share a common relationship as debtors to the same creditor.

**Franchise Groups:** Life insurance provides coverage for small groups of employees. However, each participant is issued an individual policy instead of a master [contract](#). This type of insurance requires individual underwriting and each participant could be charged a different premium rate. The policy remains in force for each individual as long as he or she maintains a valid relationship with the employer and pays the required premiums.

It is important to note that under various laws, a minimum of 10 individuals are required to qualify as a group.

## 1. Multiple Employer-Employee Groups

Multiple employer-employee groups also can be referred to as multiple-employer trusts (METs). This arrangement allows small employer-employee groups to join and receive the same group insurance considerations as larger employers. A group must have a minimum number of people (generally 10) in order to be eligible for the group insurance.

A **multiple-employer trust (MET)** is made up of two or more employers in *similar or related businesses* who do not qualify for group insurance on their own. Before HIPAA defined small employers, many small companies were unable to get health insurance at a reasonable cost because there weren't enough employees to insure. In situations like this, several small companies banded together to create a large pool of people so that the insurance company would provide coverage. This group of employers jointly purchase a single benefits plan to cover employees of each employer.

A noninsured plan may operate without the services and funds of an insurance company. Once the trust fund is established, it can pay for employees' health care expenses or life insurance death benefits directly (self-funding). The trustee has charge of the funds, and all financial activities occur through it. As with any self-funded program, the employer assumes legal responsibility for providing coverage, and the employee has no conversion right upon leaving the group coverage.

**Multiple employer welfare associations (MEWAs)** can be any entity, other than a duly admitted insurer, that establishes an employee benefit plan in order to offer or provide

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A MEWA is similar to a MET, except that MEWAs are groups of employers that pool their risks in order to *self-insure*. These groups could be sponsored by an insurance company or an independent administrator who may help a MEWA to design a plan or handle the administration. Groups can be from the same or related industries because of the law of large numbers/similar risks.

## 2. Basic Group Term Life

Basic group term life insurance usually refers to the layer of group term life insurance that an employer can provide tax free to the employee (\$50,000) and spouse and dependents (\$2,000 each). This coverage is usually available on a guaranteed issue basis with no medical underwriting if the employer has 50 or more employees.

## 3. Supplemental Group Term Life

Supplemental group term life (called voluntary life insurance by some employers) is a means by which employers may make additional life insurance available to their employees at no cost to the employer. Supplemental group term life offers the same features as basic group term life, subject to a few special requirements. Most insurers require that for an employer to offer this coverage, they must have an active employee participation level of **at least 65%**. This insurance coverage is paid for by the employee with after tax dollars and allows the employee to buy [additional coverage](#) at group rates without medical underwriting. This coverage is convertible to an individual policy if the employee leaves the company.

To qualify for the supplemental life insurance without proof of [insurability](#), the employee must elect to purchase the coverage within an initial enrollment period (usually within 30 days of employment). If the employee elects to purchase the coverage after this initial enrollment period, they will have to prove insurability.

## 4. Dependent Group Term Life

Dependent group term life extends voluntary life insurance protection to the employee's entire family. The coverage is often limited to \$15,000 in coverage for the employee's spouse and \$2,500 for each dependent child. It also usually offers conversion coverage without evidence of [insurability](#) and a waiver of premium for disability.

## 5. Group Creditor Life

Banks, finance companies, credit unions, retailers, and others may qualify for group life insurance on the lives of individuals who borrow money from the creditor. Although one purpose of group creditor life insurance is to protect lenders against possible financial loss because of the death of a debtor, these companies are often in the business of selling the insurance and therefore profit from the sales directly.

The coverage is usually decreasing term life insurance with the [face amount](#) decreasing at the same rate as the outstanding loan principal. It is very common for the lender to be named as [beneficiary](#) of the policy. The premiums are added into the loan payment, so the lender collects the premium and remits it to the insurer. These life policies often include a waiver of premium provision that will pay the entire loan payment (principal, interest, and insurance premium) if the borrower (the insured) becomes disabled. This type of group life [insurance policy](#) is usually called "credit life" or "credit life & disability."

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life, Social Security survivor benefits, and income from other sources.

Payments made to a surviving spouse stop at the earlier of a specified age (such as 62) or the survivor's death. Some benefits cease at the age at which Social Security retirement payments become available or upon remarriage of the surviving spouse. Payments made to surviving children usually end when the youngest unmarried child reaches age 19.

## 7. Group Universal Life

Group universal life insurance allows covered employees and their spouses the option of contributing to a cash value fund in addition to purchasing group term life insurance.

Group universal life is a combination of group term life insurance with a cash accumulation feature. The insurer issues a master **contract** to an employer, who in turn makes it available to employees who receive certificates of coverage and pay the entire premium. Because the policy is divided into pure life insurance protection and cash value, a part of each premium goes toward mortality costs, while the balance of the covered employee's premium is placed into the cash value portion of the policy.

Premiums are flexible, not fixed. At his or her discretion, each insured can increase or decrease the premium or benefits, or borrow against the cash value. As with individual universal life policies, an employee's premium payments can be suspended and coverage will continue, as long as the cash value is high enough to meet the insurer's mortality and expense charges.

The typical group universal life contract is held by a group of 1,000 or more employees. Employees pay the entire premium for the coverage, and the employer's only outlay is for indirect costs, such as installation and administration.

A group universal life **insurance policy** contract can often be purchased as a standalone employee benefit or combined with a group term life insurance policy. An employee may participate in either or both plans.

## 8. Dependent Life

Employer-paid premiums for dependent life insurance are tax-deductible by the employer and tax-free for the employee, to the extent that the coverage is considered **incidental** – not exceeding \$2,000 of coverage for a spouse and each dependent child. When the premiums are employer-paid, \$2,000 or less of coverage for a spouse and each dependent child is excluded from a covered employee's gross income.

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## Features and Benefits of Group Life Insurance

One of the primary features of group life insurance is that it is made available to everyone in the group at much more attractive rates than would be available with an individual policy. Insurers are able to offer this advantage because of the [law of large numbers](#). The expectation is that many, many people of differing ages and health [conditions](#) will pass through the group over time. Some members will leave the group before they die, thus terminating their insurance coverage because group life is usually term insurance. New, often younger, members will join the group, generating additional life insurance premiums.

Usually only members of the very smallest groups are required to prove their individual [insurability](#), while members of larger groups often are covered automatically when they become eligible. This is typical, but there are exceptions, so it is important to know exactly how a particular insurer writes group life coverage.

### A. Benefit Schedule

A **benefit schedule** is a predetermined statement of the formula under which benefits will be provided. These benefit schedules generally base coverage amounts on five factors.

**Duration of Service:** This will reward long-term employees and may decrease an employee's incentive to leave the company. Few employees would stay with a company only because of the group coverage, its formula, or the insurance coverage provided to employees under this method.

**Occupational Classifications:** Uniform amounts of coverage are provided within each classification. The advantage of this type of formula is that it is simple to administer and is somewhat related to the employees' survivors' needs, the employees' ability to pay in the case of a contributory plan, and the employer's assessment of the employees' worth to the business.

**Combination of Factors:** Perhaps the most common formula will base the amount of insurance on a multiple of the employee's income — from one to three times earnings. Most insurers require a minimum of \$5,000 on each covered employee, or even \$10,000 in the case of small groups. Some insurance companies may require a minimum coverage for the entire group. However, most insurance companies will issue up to \$500,000 or more on any particular life. Group insurers use medical examinations for ultra-large amounts, sometimes establish special reserves, and reinsure at least a portion of the coverage.

**Earnings:** Proponents of an earnings basis schedule point out that this type of formula benefits survivors by providing an amount equal to a full salary for a limited time after death. Because it is tied to salary, it will tend to increase with inflation. The employees who may be more productive and are consequently paid more are rewarded accordingly. If the plan requires contributions, cost is directly related to the employee's ability to pay.

**Flat Benefit:** This provides a flat benefit amount for all participants, thus being the easiest formula to administer. This type is a very good choice for large multiple-employer groups providing coverage under collective bargaining agreements.

## B. Master Contract

With group life insurance, only one policy is issued. The master **contract** is held by a master **policyowner**, such as the employer.

The **master contract** details the coverage just as any other life **insurance policy** does, but instead of individual policies, employees/insureds receive certificates of insurance as proof of coverage. This certificate provides essential information about who is covered, when the coverage takes effect, how long it lasts, the amount of insurance provided, and claims procedures. Usually these certificates are included in the announcement booklet distributed to the insured at the time a group life insurance plan is installed or during new employee orientation when the employee joins the group.

Because the employer is considered the master policyowner, it is responsible for paying premiums to the insurance company, although the employee may share in the payment of the policy premiums.

When the employer signs the master contract, it will be assured that the insurance company cannot refuse to renew the contract as long as the employer wishes to continue coverage and pays the premiums. However, the insurer has the right to increase the premium rates. According to the master contract, the insurance company also will have the right to cancel the contract if the number of employees falls below a specified number.

There are 4 important clauses in the master contract:

1. **Grace Period:** This period generally lasts for 31 days after the premium is due.
2. **Claims Limitation:** A **death benefit claim** must be made within 1 year of the last premium paid for a deceased employee.
3. **Adjustment in Premiums Clause:** When an employee's age is overstated, the employer will receive a refund. However, if it is understated, there is no change in the employee's coverage, but the employer will be required to make up the difference in premiums.
4. **Incontestability Clause:** The policy is incontestable, unless fraudulent activity is involved.

## C. Eligible Employees

Not all employees are necessarily eligible for group life coverage. Rules for eligibility can vary among groups, as long as the rules are neither discriminatory nor unfair to the insurance company. In some cases, only employees who are paid a specified minimum salary are eligible. Very commonly, only full-time employees are eligible, while part-time and seasonal employees are not.

### 1. Contributory and Noncontributory Plans

When the employer pays the entire premium with no contribution from the employee, the plan is **noncontributory**. When the employer pays all of the premiums, 100% of eligible employees must be included in the plan to prevent discrimination. Discrimination is illegal. Plans that require any premium payment from employees are called **contributory**. In this plan, employees have an option to be covered or not. However, usually at least 65% to 75% (depending on the insurer) of the eligible employees must participate. A high percentage is required to maintain profitability and to avoid **adverse selection**.

## 2. Conversion Privilege

Some group life insurance plans permit the covered person to convert the group term life insurance coverage to an individual cash value policy if the employee leaves the group. If an employee terminates membership in the insured group, the employee has the right to convert to an individual **whole life** policy *without proving insurability* at a standard rate, based on the individual's attained age. The **face amount** or **death benefit** will be equal to the group term face amount but the premium will be higher. The employee usually has a period of **31 days after terminating** from the group in order to exercise the conversion option. During this time, the employee is still covered under the original group policy.

Other rules that apply to conversion involve the death or disability of the insured, and termination of the master policy. If the insured dies during the conversion period, a death benefit equal to the maximum amount of individual insurance which would have been issued must be paid, whether or not the **application** for an individual policy was completed. If the master **contract** is terminated, every individual who was insured under the master plan will be given the option to convert to individual permanent insurance of the same face amount.



### 3. Group Term Life Beneficiary

Each covered employee has absolute freedom to name any **beneficiary**, but some states prohibit naming of the employer as a beneficiary. Otherwise, the employee may change the beneficiary as often as desired.

If the named beneficiary does not survive the insured and there is no secondary beneficiary named, the **death benefit** will be paid to the estate of the covered employee or to a "successive beneficiary" specified in the master **contract**.

In other words, the master contract may give the insurer the option to pay the proceeds to one or more of the following survivors: spouse, parents, children, brothers, sisters, or the estate's executor. If the master contract contains a **facility of payment clause**, it will allow the insurer to pay part of the proceeds to a person who has incurred funeral or last illness expenses for the covered employee.

### D. The Working of Group Life Insurance

Planning for the financial consequences of a premature death is an essential part of every financial plan. Generally, the consequences are simply too large to ignore and cannot be totally covered with individual resources. Life insurance protects a family against the risk of the premature death of the breadwinner or spouse. Life insurance planning should consider a family's short- and long-term needs. The starting point for an effective life insurance plan is to identify whether a risk exists and to define the financial impact of a premature death as a specific dollar amount. Several methods are used to quantify this amount.

All group life insurance policies are covered under Code Section 79. This means that they can receive the favorable tax treatment afforded to group term life insurance, assuming that certain requirements are met.

ERISA has many requirements for a group life insurance plan to meet in order to qualify. One is for the plan to be established and maintained in writing. The plan document must provide a procedure of amending the plan, should the occasion arise, and plan documents must provide one or more "named fiduciaries" who administer the plan.

The plan documents must specify the basis on which payments are to be made to and from the plan. The claims review procedure of the plan has the following prerequisites for a group term life policy:

- Benefits must be provided under a policy carried directly or indirectly by the individual's employer.
- The plan's benefits must be offered to a group of employees as compensation for their services.
- The amount of insurance provided to each employee must be computed under a certain formula before an individual selection.
- The plan must provide a specific **death benefit** that meets the definition of the life insurance **contract**.

## 1. Considering Experience Rating

**Experience rating** means that premiums and/or dividends in the future are based at least in part on the number of deaths and administrative costs of the specific employer's actual group, rather than by the experience of a larger pool of employers. Experience ratings are usually based on the claims and expense experience of groups of 200 or more employees. Premiums of smaller employers typically will be based on the experience of a large pool of employers covered by similar master contracts.

In a **pooled rate** situation, a uniform rate is applied to all the groups in the pool. Competition for group sales may have some effect on the size of employer that is experience-rated and the amount of the ratings. Group term premiums are recalculated annually and are based on the average age of the group, which is then adjusted for the aggregate experience. This is often called census rating.

Insurance companies renew group term life insurance annually and may adjust premiums up or down, or guarantee an upper limit for a specific period of time. Experience ratings should be considered when the group is large, employees covered in the group are young, and a steady number of young, healthy individuals comes into the plan, all of which lead to below-average claims.

## 2. Considering Tax Implications

For the first \$50,000 of life insurance coverage provided by the group plan, an employee does not have to report any income. Even though this term insurance protection is income tax-free, an employee must report and pay income tax on the economic benefit for coverage in excess of \$50,000 if the premiums are 100% employer paid.

The amount reportable is computed by multiplying Table I rates by the amount of coverage in excess of \$50,000. Monthly rates are then added to determine the total annual economic benefit received and reportable by the employee. In the event that the policy is a contributory plan, the employee may reduce the reportable amount by

the amount of coverage attributable to premiums paid with after-tax dollars by the employee.

There are tax benefits for those participating in group insurance plans, so the laws regulate exactly what constitutes an eligible "group." One of the most fundamental features is that all members have some kind of relationship in common.

The **premiums** that an employer pays for life insurance on an employee, whereby the policy is for the employee's benefit, are tax-deductible to the employer as a business expense. This includes group term insurance, in which the premiums that are attributable up to the first \$50,000 of life insurance are not taxable to the employee.

## E. Advantages and Disadvantages of Group Life Insurance

### Advantages:

- Enables terminated employees, through the conversion privilege, to convert to individual policies without submitting evidence of **insurability**.
- Allows the employer to deduct premiums for the group life **insurance policy**.
- Facilitates the satisfaction of an employer's moral obligation to the dependents of employees.

### Disadvantages:

- Group life insurance coverage must be provided for a number of employees. This increases the employer's cost significantly over nondeductible plans that allow the employer to "pick and choose" who will be covered and on what terms.
- By design and formula, group life insurance protection usually ceases or is reduced significantly at retirement.
- The employer's **out-of-pocket costs** can skyrocket if no new employees enter the plan and the amount is due to the annual renewable term aspect of the group life insurance.
- It is temporary and seems to run out or at least is significantly reduced at the very time that it is needed by the **policyowner** or the beneficiaries. This reduction particularly affects wealthy policyowners with high post-retirement living standards.
- It is a welfare benefit plan, so it is subject to certain ERISA limitations and requirements, including certain reporting obligations.
- A group term life plan cannot cover shareholders who are not employees. Who will be covered, the amount of coverage, and the terms and **conditions** of coverage must be nondiscriminatory and in writing.
- Employees have no guarantee that group coverage will be continued by the employer, because a group policy is a contract solely between the employer and the insurer. It therefore may be discontinued or changed with the particular employee's approval.

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## Business Insurance Considerations

Businesses use life insurance for the same reason individuals use life insurance: It creates an immediate payment upon the death of the insured.

The most common use of life insurance by businesses is as an employee benefit, which serves as a protection for employees and their beneficiaries. There are also other forms of life insurance that can serve business owners and their survivors, and even protect the business. These include funding business continuation agreements, compensating executives, and protecting the business against financial loss resulting from the death or disability of key employees.

### A. Six Business Concerns

Owners and presidents of companies have definite business concerns. We will start by identifying these needs before we talk about how life insurance can meet them.

#### 1. Expansion

*How concerned are you that your cash flow, credit lines, and business surplus will be available to meet plans for expanding your business?* Business thrives on a positive cash flow. Establishing the most effective strategy for making sure money is available when needed is essential for a growing business.

#### 2. Tax Advantage

*How concerned are you about getting all of the tax relief to which you are legally entitled, and that is suitable and logical for a business?* Increasing taxation in the business world is a real, serious problem for a business attempting to fund its growth with cash flow. The bite of taxation can inhibit or even kill the growth efforts of a company.

#### 3. Safety

*How concerned should you be about your ability to recover all or most of the investment made into the business?* Some businesses take a very conservative approach to operations and expansion, while others show a higher level of risk taking.

#### 4. Recruitment

*To what extent should you be concerned that the cash flow of the business helps to recruit and retain key executives and employees?* The market for middle and upper management or people with specialized skills is extremely competitive. Being able to meet the competition and attract and hold key people will be even more important in the future.

#### 5. Transfer

*How concerned should you be that your plans contribute to an orderly [transfer](#) of the company (at a top price) upon retirement, the sale of the company, or in the event of a*

## 6. Personal N Practice Question

Products and  Quiz

owner's company and determine whether or not they pay from personal funds. *interested is one in using business dollars to fulfill personal needs wherever possible?*

Increasing business taxes may dictate that those items that afford tax deductions must be paid for by the business, and those that do not must be apportioned between the business and the personal pocketbook.

### B. Business Overhead Expense

A **business overhead expense plan** helps to protect a company or owner-operator from the financial difficulties associated with a disability. Fixed overhead expenses can constitute a major portion of a company's operating budget. If a certain individual's on-the-job performance is critical to the operation of a business, that person's disability can be devastating. Fortunately, the IRS recognizes the significant difficulties that a disability can impose on a company and provides for a tax-advantaged plan to minimize financial repercussions.

An **overhead expense disability policy** reimburses a company or individual for overhead expenses incurred, with a set maximum during a covered disability. If this type of **contract** is used, the premiums paid are **deductible** as a business expense. When proceeds are paid out during a disability, they are taxable as income. Then, when the business overhead expenses are paid, they are typically tax deductible.

If a standard disability contract is used instead of an overhead expense disability policy, the premiums are not tax deductible. However, the proceeds that are received during a period of disability are not taxed as income. Even if the proceeds are used to pay business overhead expenses, the premiums are not tax deductible, and the proceeds are tax exempt if a standard disability contract is used. The set amount of the benefits is not dependent on the amount of business overhead expenses.

When developing a business overhead expense plan, a company or owner-operator should carefully consider the tax ramifications of the different types of insurance policies. He or she must decide whether current tax deductions for premiums paid or tax-exempt proceeds are most important.

### C. Business Life Insurance Needs Analysis

A study conducted by Dun & Bradstreet indicated that 47% of business failures are attributable to a lack of management and finances. The death of a key employee can cause serious problems for the business. Life insurance is used in business applications to insure key employees, fund buy-sell agreements, and serve as an important part of various compensation arrangements, such as death-benefit only plans, split-dollar arrangements, qualified pension plans, and nonqualified deferred compensation plans.

The primary function of life insurance is to offset the economic loss that comes with the death of an individual to compensate for the human value that disappears with death. People tend to insure their physical assets against loss from fire, tornadoes, and other hazards. Yet, protection against the loss of human life values, which is provided by life insurance on key people, may be far more vital. The probability of loss

## D. Evaluating Practice Question

Financial state  Quiz

business life insurance needs. Let's look at some of the indicators from the financial statements:

- **Funding Buy-Sell Agreements** — A balance sheet will often disclose how a company's present buy-sell agreement is funded or how a proposed insurance plan could be funded. The presence or absence of insurance cash values on a balance sheet calls for further investigation into the prospect's business continuation plans.
- **Absence of Cash Values** — The absence of cash values on the balance sheet might indicate that the company has a business continuation plan that either is not funded by life insurance, is funded by term insurance, or is funded by a permanent policy that has yet to show cash values. It is possible that the company has neither a business continuation plan nor enough present insurance to fund one.
- **Presence of Cash Value** — The presence of life insurance cash amount on the balance sheet indicates that the company has either an entity-purchase business continuation plan, or the company has purchased insurance for some purpose other than to fund a buy/sell.

Whether or not a balance sheet contains insurance cash values, an agent should investigate the prospect's business continuation plans in order to determine the correct need with the company.

The presence of a buy-sell agreement should not discourage an insurance agent from investigating to determine if the needs are completely covered. An insurance agent can take the most current balance sheet and compare it to the one for the year in which the agreement was last considered.

## E. Determining the Amount of Key Employee Insurance

The key executive's employer often has a difficult time arriving at the amount of insurance it should purchase on the employee's life. The employer deals with human life values, not property values, so no set formula or rule can be used. *For example*, the determination of insurance amounts in a buy/sell insurance case is much more precise because the assessment of the insurance amounts is determined largely by the property values. In many key-executive insurance cases, however, the amount of insurance will be established in a more or less arbitrary fashion.

There are a few points that might be considered in reaching a reasonable figure. Let's look at these questions and possible answers.

- **How much would it cost to replace the person in question?** A new person would have to be hired to take the key employee's place at death. Would the new individual demand more salary? Would the new individual do the job as well? How long would it take to train the new person to reach the proficiency level of this key employee? How much could the company be expected to spend in finding and training a capable successor?
- **What proportion of the company's actual loss is it willing to insure?** What proportion of the company's desire to insure completely against the loss of the key individual may be limited by working-capital considerations?
- **How much is this person worth to the firm in net profits?** The executive is making a definite contribution to the firm's success and is accountable for some

Select Chapter ▼



WVUWUWU LIFE

🔍 Practice Question

## F. What Life

☑ Quiz

Life insurance

death strikes, but it can **indemnify** the business for the cash value of the services that will be lost, to the extent that human life values can be measured. Life insurance can provide the business with cash to do any of the following:

- Cover the expenses of finding, securing, and training a new person to take the deceased's place;
- Assure creditors that their loans are safe;
- Assure customers that the business will continue operations;
- Keep the business running;
- Cover the mistakes that the replacement employee makes until he or she learns the things that the deceased knew; and
- Be made available for many uses that cannot be predetermined because they depend upon the particular circumstances of that business at that time.

The key executive is vitally important to the continued welfare of the firm. Without insurance to offset the loss of a key person's death, there may be a very serious interruption of the flow of business profits.

## G. Consumer Application

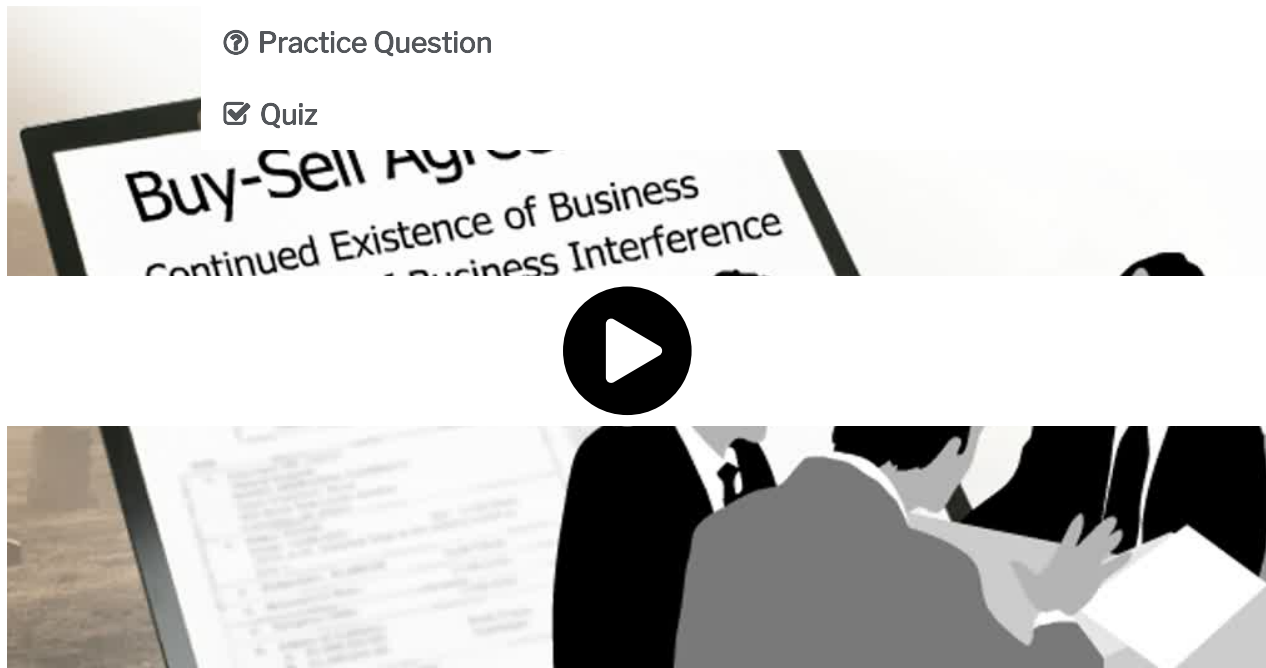
### Scenario #1: Buy-sell Agreement

Two partners, each married to a nonworking spouse, opened a retail hardware store and want to protect each other in case one should die. They have their attorney draw up a buy/sell agreement, whereupon, if either of them should die, the other agrees to buy out the deceased partner's share. The business is capital intensive, which means that the inventory and store expenses do not allow the owners to have a great deal of money sitting in the bank. They agree that the value of their business is \$1 million, so if either of them should die, the other would have to give the surviving spouse \$500,000. They determine that the only practical way to fund the agreement is for each of them to buy a \$500,000 **insurance policy** on the other.

Choices for the buy/sell:

- Term insurance is the least expensive option and affords maximum coverage for the premium dollar. The cost can rise dramatically in later years.
- Whole life provides a level premium and tax-deferred cash accumulation with the ability to take loans against the cash values. The cost may be prohibitive for higher face amounts.
- Adjustable, universal, and variable adjustable life are all possible choices, with the same provisions as whole life. Additionally, these plans offer flexible premiums and potentially greater cash accumulations through the use of the underlying investment funds.

Select Chapter ▼



### Scenario #2: Key Person

An owner operates five fast food establishments and hires a general manager to oversee all the operations. If the manager were to die, the owner would have to search for, hire, and train a new manager. Because the manager works approximately 50 hours per week, the owner estimates it would cost the business \$50,000 in expense and lost profits to replace him.

### Scenario #3: Key Executive

A publicly traded company in the computer industry has 16 executive vice presidents (EVPs) who oversee national and international manufacturing operations. If any of those EVPs were to die, company operations and profits would suffer. These executives hold advanced degrees and have experience that is difficult to replace. Being publicly traded, the EVPs have newsworthy visibility; if any were to die, the company's stock price might be affected. The company estimates that if any of the EVPs were to die, the company would lose in excess of \$5 million. In this case, the key executive life [insurance policy](#) could protect the company against this kind of loss.

## H. For Florida Producers Only

### **Unauthorized Entities:**

An entity that is required to be licensed or registered with the Florida Office of Insurance Regulation, but that is operating without the proper authorization, is identified as an [unauthorized insurer](#). All persons have the responsibility of conducting reasonable research to ensure they are not writing policies or placing business with an unauthorized insurer. Any person who, directly or indirectly, aids or represents an unauthorized insurer can lose his or her licenses, or face other disciplinary sanctions. Lack of careful screening can result in significant financial loss to Florida consumers due to unpaid claims and/or theft of premiums. Under Florida law, a person can be

Select Chapter ▼



represent. (P) Practice Question

I. Course Re Quiz

1. Exam Breakdown

The Exam Breakdown should be used to see where to focus your valuable study time. Each test is weighted per chapter, so concentrating your efforts will benefit you when taking the actual exam.



**Life Insurance Policy Types & Suitability - Final Examination**  
**50 Questions - 2-hour time limit**

Chapter	Percentage of Exam
The Basics of Life Insurance	2%
Understanding Needs Analysis	4%
Determining the Amount of Life Insurance	2%
The Elements of Life Insurance	4%
Understanding the Life Insurance Contract	4%
Understanding the Features & Benefits of Life Insurance	6%
Life Policy Features and Benefits - Policy Loans	2%
Term Life Insurance	6%
Whole Life Insurance	6%
Types of Whole Life Insurance	6%
Understanding Flexible Premium Products: Adjustable Life	4%
Workings of Adjustable Life Insurance	6%
Universal Life Insurance - Overview	6%
Universal Life Insurance - Features and Benefits	6%
Universal Life Insurance and Taxes	4%
Variable Life Insurance	6%
Types of Variable Life Insurance and Other Related Concepts	4%
Variable Universal Life Insurance	6%
Group Life Insurance	6%
Features and Benefits of Group Life Insurance	6%
Business Insurance Considerations	4%

Select Chapter ▼

*Insurance Poli*

🔍 Practice Question

<http://www.acl>*Insurers (ACLI*,  Quiz[www.irs.gov](http://www.irs.gov), *Publication 590 (2011)*[www.irs.gov](http://www.irs.gov), *Retirement Plan FAQs Regarding Contributions*<http://www.retirementplans.irs.gov/plan-comparison-table/>, Internal Revenue Service, *IRS Retirement Plans Navigator*<http://www.dol.gov/compliance/laws/comp-erisa.htm> ERISA, U.S. Department of Labor, *The Employee Retirement Income Security Act (ERISA)*[www.finra.complinet.com](http://www.finra.complinet.com), *FINRA Manual*[http://www.ssa.gov/policy/docs/quickfacts/stat\\_snapshot](http://www.ssa.gov/policy/docs/quickfacts/stat_snapshot), Social Security Online, *Monthly Statistical Snapshot, February 2012*<http://www.ssa.gov/pressoffice/IncRetAge.html>, Social Security Online, *Social Security Fact Sheet*<http://www.investopedia.com/terms/f/fixedannuity.asp>, *Investopedia*

## Chapter Complete

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