CLIFF NOTES

PREPARING PEOPLE TO PASS

XCEL TESTING SOLUTIONS

TEXAS - LIFE

Basic Principles of Life and Health Insurance and Annuities

- **TYPES OF INSURANCE COMPANIES**

Multi-line insurer: An insurance company selling more than one line of insurance

Commercial Insurers: are in the business of selling insurance for a profit. Commercial insurance is divided into two main groups: stock and mutual insurers.

•**Stock Companies** are incorporated companies owned by their stockholders. **Dividends from a stock company are paid to stockholders.** Traditionally, stock insurers are called **nonparticipating insurers** because policyholders do not receive dividends. Transformation of a stock insurer into a mutual insurer is termed mutualization, and the reverse is termed demutualization. Although stock companies can give dividends and not give dividends, when they do, they are operating on a mixed plan. In this case, dividends are taxable.

•**Mutual Companies** are commercial insurers that are owned by their policyholders. **Mutual company dividends are paid to the policyholders.** Since mutual insurers issue dividends to policyholders, they are referred to as **participating insurers**. Although mutual companies almost always give dividends, they can never guarantee them. In this case, dividends are not taxable.

Fraternal benefit societies are special types of mutual companies/ nonprofit religious, ethnic or charitable organizations that provide insurance solely to their members. For example, Knights of Columbus.

Lloyd's of London is not an insurance company. Members of the association form syndicates to underwrite and issue insurance- like coverage. This is a group of investors who share in unusual risk.

Risk retention groups are mutual companies formed by a group of people in the same industry or profession. Examples would be pharmacists, dentists, and engineers.

Participating company is a life insurance company that shares its surplus earnings with its insureds. Nonparticipating companies do not.

Reciprocal insurers are unincorporated groups of individual members that provide insurance for other members through indemnity contracts. Each member acts as both insurer and insured and are managed by Attorney in Fact.

Reinsurers make arrangements with other insurance companies to transfer a portion of their risk to the reinsurer. The company transferring the risk is called the **Ceding Company** and the company assuming the risk is the **Reinsurer.**

Assessment insurers assess policyholders a premium only when losses are incurred.

Home Service Insurers: home service insurance is **industrial insurance** sold by home service or **debit** life insurance companies. Face amounts are small; usually $1,000 to $2,000 and premiums are paid weekly.

Government Insurance: Social insurance provides protection against universal risks by redistributing income to help people who cannot afford the cost of incurring such losses themselves.

Types of Government Insurance: Social Security – Medicare – Medicaid
S.G.L.I. - Serviceman's Group Life Insurance, which is life insurance for members of the military.
Tri-Care – this is health insurance for members of the military.

Self Insurers retain risks and must have a large number of similar risks and enough capital to pay claims. However, they may save money if the loss experience is lower than the expected costs.

- **HOW INSURANCE IS SOLD**

Distribution Systems are the ways insurance products are marketed and sold to the public. Insurance can be purchased through licensed insurance producers, who are either agents or brokers, or through a number of other ways. Agents are either captive/career agents or independent agents. Captive agents work for only one insurer. Independent agents work for themselves or for several insurers non-exclusively.

Career Agency System: With the career agency system commercial insurers establish offices in certain locations. Career agents are recruited to work at these locations. A general agent hires and trains new producers and supervises a number of other producers. All producers under the career agency system are captive agents and employees of the insurer.

Personal Producing General Agency System: With the personal producing general agency (PPGA) system, agents work for an independent agency selling policies from several insurance companies. Unlike the career agency system, agents are not employees of the insurance company. Instead, they work for the PPGA. Furthermore, personal producing general agents primarily sell insurance, instead of recruiting and training new agents as in the career agency system.

Independent Agency System (American Agency System): Independent agents **represent a number of insurance companies under separate contractual agreements.** They may also work for themselves or under other insurance agents. Independent insurance agents have control and ownership over their clients' accounts. This means they may place clients' business with a different insurer when policies are up for renewal. Independent insurance agents earn commissions on the sales they make and overrides on sales made by agents they manage.

Managerial System: With the managerial system, branch offices are established in several locations. Instead of a general agent running the agency, a salaried branch manager is employed by the insurer. The branch manager supervises agents working out of that branch office. The insurer pays the branch manager's salary and pays him a bonus based on the amount and type of insurance sold and number of new agents hired.

Mass Marketing: Another way to sell insurance is through mass marketing methods. Direct selling is a mass marketing method where agents are not used. Instead, policies are marketed and sold through television and radio advertisements, print sources found in newspapers and magazines, by mail, in vending machines, and over the internet.

INDUSTRY OVERSIGHT AND REGULATION

The insurance industry is primarily regulated on a state-by-state basis with minimal federal oversight.

- **Paul v. Virginia case of 1869** the U.S. Supreme Court ruled that insurance transactions crossing state lines are not interstate commerce.
- **1944 United States v. South-Eastern Underwriters Association** ruled that insurance transactions crossing state lines are interstate commerce and are subject to federal regulation.
- **The McCarran Ferguson Act** states that while the federal government has authority to regulate the insurance industry, it would not exercise its right if the insurance industry was regulated effectively and adequately on the state level.
- **The Armstrong Investigation Act** gave the authority to the states to regulate insurance.
- **Fair Credit Reporting Act:** provides individuals privacy protection and fair and accurate credit reporting. Insurance companies are required to notify applicants if a credit check will be made on them.
- **Financial Services Modernization Act**: This law repealed the Glass-Steagall Act; this allows Banks, Retail Brokerages and Insurance companies to enter each other's line of business.

Guaranty Associations: State life and health guaranty associations provide a safety net for all member life, health and annuities insurers in a particular state. Guaranty associations protect insureds in the event of insurer insolvency, or inability to pay claims up to a certain limit.

The National Association of Insurance Commissioners (NAIC)

The (NAIC) is an organization composed of insurance commissioners from all 50 states, the District of Columbia and the 4 US territories. They are responsible for recommending appropriate laws and regulations. They are responsible for the creation of the **Advertising Code** and the **Unfair Trade Practices Act.**

The NAIC has four broad objectives:

1. To encourage uniformity in state insurance laws and regulations
2. To assist in the administration of those laws and regulations by promoting efficiency
3. To protect the interest of policyowners and consumers
4. To preserve state regulation of the insurance business

NAIFA and NAHU - Members of these organizations are life and health agents dedicated to supporting the industry and advancing the quality of service provided by insurance professionals

These organizations created a Code of Ethics detailing the expectations of agents in their duties toward clients.

Independent Rating Services are credit rating agencies that rate or "grade" the financial strength and stability of insurers based on claims, reserves, and company profits. The nationally recognized statistical rating organizations that rate insurers are **A. M. Best, Moody's, Standard and Poor's, and Fitch Ratings.** Each rating service has its own rating system, but most use an A to F letter grading scheme.

Legal Concepts of the Insurance Contract

Insurance policies are legal contracts. Contract law defines a contract as a legally binding agreement between two or more parties where a promise of benefits is exchanged for valuable consideration. The purpose of an insurance policy is to indemnify (make whole) the insured when a covered loss occurs.

- **Life insurance:** the insurance company agrees to pay a predetermined amount – **the face amount,** in exchange for consideration **(premium)**.
- **Health insurance:** the insurance company agrees to pay a percentage of the insured's **medical bills** in exchange for consideration **(premiums**).

➢ ELEMENTS OF THE CONTRACT

Four elements must be present in every contract to be valid and legally enforceable. These elements include:

1. **Consideration**
2. **Legal Purpose**
3. **Offer and Acceptance**
4. **Competent parties**

Consideration: Consideration is something of value that each interested party gives to each other. The insured provides **consideration** with **payment of premium**. The insurer provides consideration by **promising to pay** the insurance benefit.

Legal Purpose: An insurance contract must be legal and not in opposition of public policy. If an insurance contract has **insurable interest** and the insured has provided written consent, it has **legal purpose**. Without legal effect, the contract would be null and void.

Offer and Acceptance: An offer is made when the applicant **submits an application and money** for insurance to the insurance company. The offer is accepted after it has been **approved** by the insurance company's **underwriter** and issues a policy. If no money is given, the applicant is making an invitation.

Competent Parties: <u>All parties must be of legal competence, meaning they must be of **legal age**, **mentally capable** of understanding the terms, and **not influenced by drugs or alcohol.**</u>

➢ SPECIAL FEATURES OF INSURANCE CONTRACTS

Insurance contracts have the following unique characteristics:

Contract of Adhesion: Because an insurance contract has been prepared by an insurance company with no negotiation, it is considered a contract of adhesion. In a contract of adhesion there is only one author – the insurance company. If there is an ambiguity in the contract, the courts always favor the insured over the insurer.

Aleatory Contract: Insurance contracts are aleatory, which means there is an unequal exchange. The premiums paid by the applicant is small in relation to the amount that will be paid by the insurance company in the event of a loss.

- Consideration may be unequal
- The outcome depends on chance or uncertain event
- A legal bet is considered an aleatory contract

Unilateral Contract: One sided agreement, where only the insurer is legally bound. In an insurance contract only the insurance company is legally bound to do anything.

Conditional Contract: Insurance contracts are conditional because certain conditions must be met by all parties in the contract. This is needed when a loss occurs in order for the contract to be legally enforceable.

Valued vs. Indemnity: Life insurance contracts are **valued** contracts, which means it will pay a stated amount. **Health insurance** contracts are **indemnity** contracts and will only reimburse the actual cost of the loss (pay medical bills, etc.) You cannot profit from an indemnity contract.

Utmost Good Faith: Implies that there will be no attempt by either party to misrepresent, conceal or commit fraud as it pertains to insurance policies.

Warranties: Statements made by the applicant guaranteed to be true – (name, DOB)

Representations: Statements made by the applicant believed to be true – (height, weight)

Concealment: Witholding of information or facts by the applicant – (smoker, diabetes)

Insurable Interest: Requires that an individual have a valid concern for the continuation of the life or well-being of the person insured. Without insurable interest, an insurance contract is not legally enforceable and would be considered a wagering contract. **NOTE: Insurable interest only needs to exist at the time of the application (the inception of the contract).**

Reasonable Expectations: <u>A concept which states that the insured is entitled to coverage under a policy that a sensible and prudent person would expect it to provide</u>**.** <u>Reinforces the rule that ambiguities in insurance contracts should be interpreted in favor of the policyholder.</u>

Stranger-Originated Life Insurance: In Stranger-Originated Life Insurance, or **STOLI**, a consumer purchases a life insurance policy with the agreement that a third party agent/broker or investor will purchase the consumer's policy and receive the proceeds as a profit upon the consumer's death.

➢ AGENT AUTHORITY

<u>A relationship in which one person is authorized to represent and act for another person or company is established through the law of agency.</u> In applying the law of agency, the insurance company (insurer) is the principal. An agent or producer will always be deemed to represent the insurance company and not the applicant. In regards to the insurance contract, any knowledge of the agent is considered to be the knowledge of the insurance company (insurer). If the agent is working within the conditions of his/her contract, the insurance company is fully responsible.

- Agents are granted **authority** through the agency contract to transact insurance or adjust claims on their behalf. Some common tasks agents are authorized to perform include **solicit applications, collect premiums, and render services to prospects.**

The following are the three types of agent authority:

- Express
- Implied
- Apparent

Express: Express authority is the explicit authority granted to the agent by the insurer as written in the agency contract.

Implied: The unwritten authority of a producer to perform incidental acts necessary to fulfill the purpose of the agency agreement (otherwise unwritten in the contract).

Apparent: Apparent authority deals with the relationship between the insurer, the agent, and the customer. It is the appearance of authority based on the agent-insurer relationship. Apparent authority is a situation in which the insurer gives the customer reasonable belief that an agent has the power and authority to bind the principal.

- **Fiduciary Responsibility –** Because the agent handles money of the insured and insurer, he/she has a fiduciary responsibility. A fiduciary is someone in a position of trust. With insurance, for example, it is illegal for agents to mix premiums collected from applicants with their own personal funds. This is called <u>commingling.</u>

➢ OTHER LEGAL CONCEPTS

Fraud: Fraud is an intentional misrepresentation or concealment of material fact made by one party in order to cheat another party out of something that has economic value. <u>An insurer may void an insurance policy if a misrepresentation on the application is proven to be material</u>.

Waiver: <u>Waiver is the voluntarily giving up of a known right.</u>

Estoppel: The legal process of preventing one party from reclaiming a right that was waived.

Parol Evidence Rule: Rule that prevents parties in a contract from changing the meaning of a written contract by introducing oral or written evidence made prior to the formation of the contract but are not part of the contract.

Void and Voidable Contracts: A void contract is an agreement that doesn't have legal effect, and therefore is not a contract. Void contracts are not enforceable by either party. Unlike a void contract, a voidable contract is a valid, binding contract which can be voided at the request of a party with the right to reject.

Life Insurance Policies

➢ TYPES OF LIFE INSURANCE POLICIES

The following are the three main types of life insurance:

1. **Ordinary life:** Is made up of several types of individual life insurance, such as temporary **(term)**, permanent **(whole)**

   Term life: insurance provides pure death protection since it only pays a death benefit if the insured dies during the policy term.

   - Term life insurance does not accrue cash value.
   - **Term life is meant for those who need the greatest amount of life insurance for a specified period of time at the lowest premium**
   - **The initial premium of term insurance is lower than for an equivalent amount of whole life insurance**

   Whole life: insurance that provides death benefits for the entire life of the insured. It also provides living benefits in the form of cash values. It matures at age 100 and normally has a level premium.

2. **Industrial life:** insurance issues very small face amounts, such as $1,000 or $2,000. Premiums are paid weekly and collected by debit agents. They were designed for burial coverage.

3. **Group life:** insurance written for members of a group, such as a place of employment, association, or a union. Coverage is provided to the members of that group under one **master contract.** The group is underwritten as a whole, not on each individual member. One of the benefits of group life coverage is usually there is no evidence of insurability required.

Types of Term Life

Level term: also called level premium level term, has a level face amount and level premiums. Premiums tend to be higher than annual renewable term because they are level throughout the policy period. However, the premiums will increase at each renewal.

Decreasing term: Term life insurance that provides an **annually decreasing face amount over time** with **level premiums**. These policies are usually used for **mortgage protection.**

Increasing term: Term life insurance that provides an **increasing face amount** over time based on specific amounts or a percentage of the original face amount.

Convertible term: A term life policy has a provision that allows policyowners to **convert their term insurance into permanent policies without showing proof of insurability.**

Renewable term: Term insurance that guarantees the insured the right to continue term coverage after expiration of the initial policy period **without having to prove insurability**.

Annual renewable term: Term coverage that provides a level face amount that renews annually. This type of coverage is guaranteed renewable annually without proof of insurability.

Whole Life Insurance: Provides both living **and** death benefits. Provides permanent life insurance protection for the insured's **entire life.** It also provides living benefits such as **cash value and policy loans.**

Advantages of whole life insurance:

- Covers the entire life of the insured
- Living benefits - cash value and policy loans
- Fixed premiums

Drawbacks of whole life insurance:

- Protection is more expensive because of living benefits
- Premium paying period may extend beyond the income-earning years

There are several types of whole life insurance such as:

1. straight whole life
2. limited pay whole life
3. single-premium whole life
4. modified whole life
5. graded whole life

Straight life: This is basic whole life insurance with a level face amount and fixed premiums payable over the insured's entire life. **Premium payments made until death of insured or age 100 (maturity of policy).**

Limited Pay life: This is whole life insurance where the insured is covered for his entire life, but **premiums are paid for a limited time. As the premium payment period shortens, cash values increase faster and the fixed premiums are higher.** For example, under a life paid-up at 65 policy, premiums are only paid until the insured is 65 years old. With a 20-pay life policy, the insured only pays for 20 years. These policies are in effect until the insured's death or they reach age 100.

Single premium whole life: Allows the insured to pay the entire premium in one lump-sum and have coverage for the insured's entire life.

- An immediate nonforfeiture value is created
- An immediate cash value is created
- A large part of the premium is used to set up the policy's reserve

Modified whole life: Low premiums in the early years and jumps to a higher premium in the later years and remains fixed thereafter. Premiums increase just once.

Graded whole life: Under a typical graded premium life insurance policy, the premium increases yearly for a stated number of years, then remains level. Premiums continue to stay level for the remainder of the policy. For example, a policy can start out low in a graded whole life and increase a small amount every year up until the fifth year, then levels off for the remainder of the policy.

➢ SPECIAL USE POLICIES

In addition to the basic types of life insurance policies, there are a number of "special use" policies insurance companies offer. Many of these are a combination or "packaging" of different policy types, designed to serve a variety of needs.

Family Plan Policies: These are designed to insure all family members under one policy. **Usually the family head is covered by permanent (whole life) insurance and the spouse/children are included on the same policy as level term life riders (family term riders) .** The term coverage on the spouse and children are normally convertible to permanent coverage without evidence of insurability.

Family Plan Policy Example:

- **Husband – Whole Life Policy**
- **Wife (spouse) – Term Policy – convertible without proof of insurability**
- **Children – Term Policies – convertible usually at age 18 or 21 without proof of insurability; premium remains same regardless of the number of children**

Family Income Policies: Whole life and decreasing term insurance (begins date of purchase). Provides monthly income to a beneficiary if death occurs during a specified period after date of purchase. If the insured dies after the specified period, only the face value is paid to the beneficiary since the decreasing term insurance expired.

Family Maintenance Policy: Whole life and level term (begins date of death). Provides income to a beneficiary for a selected period of time if an insured dies during that period. At the end of the income-paying period, the beneficiary also receives the entire face amount of the policy. If an insured dies after the end of the selected period, the beneficiary receives only the face value of the policy.

Multiple protection policies: Pays a benefit of double or triple the face amount if death occurs during a specified period. If death occurs after the period has expired, only the policy face amount is paid. The period may be for a specified number of years - 10, 15, or 20 years or to a specified age such as 65. These policies are combinations of permanent insurance and level term insurance.

Joint Life Policy: A policy that covers two or more people. The age of the insureds are **"averaged"** and a single premium is charged. It uses permanent insurance (as opposed to term) and pays a death benefit when **one** of the insureds dies. The survivors then have the option of purchasing an individual policy without evidence of insurability. The premium for a joint life policy is less than the premium for separate, multiple policies.

> **Note:** A variation of the joint life policy is the **joint and survivor policy, or a "survivorship life policy"** (it can also known as a "second to die" policy). This plan also covers **two lives**, but the benefit is paid upon the death of the **last surviving insured**.
>
> - Compared to the combined premium for separate life insurance policies on two individuals, the premium for a survivorship life policy is **lower**.

Juvenile Insurance: Life insurance which is written on the lives of a minor is called juvenile insurance. The adult applicant is usually the premium payor as well, until the child comes of age and is able to take over the payments. **A payor provision is typically attached to juvenile policies. It provides that, in the event of death or disability of the adult premium payor, the premiums will be waived until the child reaches a specified age (such as 18, 21, or 25).**

Credit life insurance: is designed to cover the life of a debtor and pay the amount due on a loan if the debtor dies before the loan is repaid. **It is normally issued in an amount not to exceed the outstanding loan balance and is usually paid entirely by the borrower. A decreasing term policy is most often used.**

➢ NONTRADITIONAL LIFE POLICIES

In the 1980s, insurance companies introduced a number of **new life products designed to keep up with inflation and are interest-sensitive,** most of which are more flexible in design and provisions than their traditional counterparts. **The most notable of these are interest-sensitive whole life, adjustable life, universal life, variable life, and variable universal life.**

Interest-Sensitive Whole Life: Interest-sensitive life insurance is a type of whole life insurance where the cash value can increase beyond the stated guarantee if economic conditions warrant. This is also called current assumption whole life insurance. It also gives the insured the opportunity to either increase the face amount or use the extra cash value to lower future premiums. Premiums can vary to reflect the insurer's changing assumptions with regard to its death, investment, and expense factors. CAWL (current assumption whole life) policies are almost always a MEC due to accelerated premiums.

Adjustable life policies: are distinguished by their **flexibility** that comes from **combining term and whole life insurance into a single plan.**

- The policyowner determines how much face amount protection is needed and how much premium the policyowner wants to pay
- **Adjustable life insurance allows you to vary your coverage as your needs change without requiring evidence of insurability**
- Consequently, no new policy needs to be issued when changes are desired
- Adjustable life has all the usual features of level premium cash value life insurance

Universal life: is a variation of whole life insurance, **characterized by considerable flexibility**.

- Changes may be made with **relative ease by the policyowner** with these flexible-premium policies
- Unlike whole life (with its fixed premiums, fixed face amounts, and fixed cash value accumulations) **universal life allows its policyowners to determine the amount and frequency of premium payments which will adjust the policy face amount**
- Basic characteristics of a universal life policy are flexible premiums, flexible benefits, no minimum death benefit, and cash value withdrawals
- Cash value accumulations are subject to a **minimum interest guarantee**
- Any surrender charges of a universal policy must be disclosed

Equity Index Universal Life Insurance (EIUL): A permanent life insurance policy that allows policyholders to tie accumulation values to a stock market index, **like the S&P 500.** Indexed universal life insurance policies typically contain **a minimum guaranteed fixed interest rate** component along with the indexed account option**. Indexed policies give policyholders the security of fixed universal life insurance with the growth potential of a variable policy linked to indexed returns.** Potential extra interest based on the investments of the company's general account.

Modified Endowment Contracts (MEC): **A policy that is overfunded, according to IRS tables, is classified as a Modified Endowment Contract.** Policies that do not meet the 7-pay test are considered MEC's and will lose favorable tax treatment. The 7-pay test is a limitation on the total amount you can pay into your policy in the first seven years of its existence. The test is designed to discourage premium schedules that would result in a paid-up policy before the end of a seven-year period. For example, if yearly premium is $500, in a seven year period a total amount paid would equal $3,500. If you paid $3,501, it has now exceeded the 7-pay test and is no longer a life insurance contract.
It will now be taxed as an investment.

- If withdrawn prior to age 59 ½, there is a 10% penalty.
- Taxation only occurs when cash is distributed
- Funds withdrawn from a MEC are subject to last-in first-out (LIFO) tax treatment, which assumes that the investment or earnings portion of the contract's values is withdrawn first (making these funds fully taxable as ordinary income).
- Penalty taxes on premature distributions from a modified endowment contract (MEC) normally apply to policy loans

➢ VARIABLE INSURANCE PRODUCTS

Note: Because of the transfer of investment risk from the insurer to the policyowner, variable insurance products are considered securities contracts as well as insurance contracts. A producer is required to register with the National Association of Securities Dealers to sell variable products.

Variable whole life insurance: was created to help offset the effects of inflation on death benefits. It's permanent life insurance with many of the same characteristics of traditional whole life insurance. The main difference is the manner in which the policy's values are invested. With traditional whole life, these values are kept in the insurer's general accounts and invested in conservative investments selected by the insurer to match its contractual guarantees and liabilities. With variable life insurance policies, the policy values are invested in the **insurer's separate accounts** which house common stock, bond, money market, and other securities investment options. Values held in these separate accounts are invested in riskier, but potentially higher yielding, assets than those held in the general account. **The basic characteristics of a variable life policy are: fixed premiums, a guaranteed minimum death benefit which fluctuates over the minimum, and cash values which fluctuate and are not guaranteed.**

Variable universal life (VUL): is a type of life insurance that builds cash value. It combines all the characteristics of a universal life and variable life. In a VUL, the cash value can be invested in a wide variety of separate accounts, similar to mutual funds, and the choice of which of the available separate accounts to use is entirely up to the contract owner. **The 'variable' component in the name refers to the ability to invest in separate accounts whose values vary**—they vary because they are invested in stock and/or bond markets. **The 'universal' component in the name refers to the flexibility the owner has in making premium payments.** This provides the policyowner with flexible premiums, adjustable death benefits, a guaranteed minimum death benefit and gives the insured growth potential for higher returns, but also potential for loss. Evidence of insurability can be required for an individual covered by a variable universal life policy when the death benefit is **increased**.

Life Insurance Provisions, Options, and Riders

➢ Required Provisions

Insuring Clause (or Insuring Agreement): **The insurer's basic promise to pay specified benefits to a designated person in the event of a covered loss.**

Consideration Clause: A policyowner must pay a premium in exchange for the insurer's promise to pay benefits. **A policyowner's consideration consists of completing the application and paying the initial premium.** The amount and frequency of premium payments are contained in the consideration clause.

Entire Contract: **The insurance policy itself, any riders and endorsements/amendments, and the application comprise the entire contract between all parties. Insurance producers cannot make changes to a policy.** The entire contract provision is found at the beginning of every life insurance policy issued. Only an authorized officer of the insurer is permitted to make changes to the contract.

Grace Period: The period of time policyowners are allowed to pay an overdue premium during which the policy remains in force, usually 30 days. If an insured dies during the Grace Period of a life insurance policy before paying the required annual premium, the beneficiary will receive **the face amount of the policy less any required premiums.**

Reinstatement: **Permits the policyowner to reinstate a policy that has lapsed**- as long as the policyowner can **provide proof of insurability** and pays all back premiums, outstanding loans, and interest. Most states allow reinstatement up to 3 years after a policy has lapsed. However, some states are 5-7 years.

Incontestable Clause: **The clause in a life insurance contract that prohibits the insurer from questioning the validity of the contract after a certain period of time has elapsed.**

Misstatement of Age or Sex: **Allows the insurer to adjust the policy benefits if the insured's age or sex is misstated on the policy application.**

Policy Loan Provisions: Policies that have **cash value** also have policy loan and withdrawal provisions. These policies must begin to build cash value after a certain number of years. In most states, this is 3 years. These loans, with interest, cannot exceed the guaranteed cash value or the policy is **no longer in force.** The policyowner has the right to the policy's cash value. Policy loans are not taxable. **Any loans with interest due at the time of death will be deducted from the insured's policy proceeds.**

Automatic Premium Loans: Allows the insurer to automatically use the policy cash value to pay an overdue premium. There is no cost for this provision.

Assignment Clause: The right to transfer policy rights to another person or entity.

- **Absolute assignment**: When the assignee receives full control of the policy and rights to the policy benefits from the current policyowner.
- **Collateral assignment**: The partial and temporary transfer of rights to another person or entity. Collateral assignments are usually intended for securing a loan with a **creditor.**

Free Look: The policyowner is permitted a certain number of days once the policy is delivered to look over the policy and return it for a refund of all premiums paid.

➢ Exclusions

Exclusions: **A feature of a life insurance policy stating that the policy will not cover certain risks.**

Suicide Clause: The policy will be voided and no death benefit will be paid if the insured commits suicide **within 1 year** from policy issuance. **The primary purpose of a suicide provision is to protect the insurer against the purchase of a policy in contemplation of suicide.**

Aviation: The insurer will not pay the claim if the insured dies due to involvement with aviation, such as a military pilot flying a jet aircraft.

War or Military Service: The insurer will not pay the claim if the insured dies while in active military service or due to an act of war.

Hazardous Occupation or Hobby: If the insured dies as a result of a hazardous occupation or hobby, the insurer will not pay the claim.

➢ Policy Options

Nonforfeiture Options

When a policyowner decides he does not want his life insurance policy anymore, he has the option to surrender his policy. If there is cash value remaining he must use one of the following nonforfeiture options:

- **Cash Surrender:** allows the policyowner to receive the policy's **cash value**. Policyowner no longer has coverage at this point. Normally, the maximum length of time a life insurance company may legally defer paying the cash value of a surrendered policy is **6 months (Delayed Payment provision).**
- **Extended Term Option:** permits the policyowner to use the policy's cash value to buy **level, extended term insurance for a specified period.** No premium payments are made. The coverage provided with the extended term nonforfeiture option is equal to the net death benefit of the lapsed policy.
- **Reduced Paid-Up Option**: the policyowner pays no more premiums but the face amount is decreased.

Dividend Options

Participating policies pay dividends to policyowners if the company's operations result in a **divisible surplus**. Recall that dividends are a return of overcharged premiums, and are therefore **not taxable**. Insurers typically pay dividends on an annual basis.

The following dividend options are available to policyowners for settling dividend payments.

- **Cash Option:** Take the cash
- **Reduced Premiums Option:** Reduces premium payments
- **Accumulate Interest Option:** Allows dividends to accumulate interest
- **Paid-Up Additions Option:** Purchase single payment whole life coverage
- **One-Year Term Option:** Purchase one-year term protection

➢ POLICY RIDERS

Waiver of Premium Rider: Allows the policyowner to **waive** premium payments during a disability and keeps the policy in force. It does **not** provide cash payments to the policyowner. The disability must be **total and permanent** and have sustained through the **waiting period (90 days or 6 months)**. After a certain age (usually 60 or 65), the waiver of premium rider is void.

Payor Rider (or Payor Clause): If the individual paying the premiums on a juvenile life policy becomes disabled or dies, the Payor Rider ensures that premiums will be **waived.**

Accelerated Benefit Rider: **Allows the insured to receive a portion of the death benefit prior to death if the insured has a terminal illness and expected to die within 1-2 years.** Whatever amount is withdrawn in an accelerated death benefit will decrease the death benefit when death occurs.

Accidental Death Benefit Rider (multiple indemnity): Pays an additional sum to the beneficiary if the insured dies due to an accident. The amount paid is a multiple of the policy face amount such as double or triple the original benefit.

Accidental Death and Dismemberment: May be added to a life insurance policy. Pays benefits for dismemberment and accidental death. Pays a principal sum for loss of both hands, both arms, both legs, or loss of vision in both eyes.

Guaranteed Insurability Rider (future increase option): Permits the policyowner to buy additional permanent life insurance coverage at **specific points of time in the future without submitting proof of insurability.** It also includes specific events like marriage and births, without requiring the proof of insurability. Usually the benefit is allowed every 3 years, up to the original face amount of the policy.

Cost of Living Rider: Allows the policy face amount to be adjusted to account for inflation based on the consumer price index.

Return of Premium Rider: pays the total amount of premiums paid into the policy in addition to the face value, as long as the insured dies within a certain time period specified in the policy. It also returns premiums to the living insured at the end of a specified period of time, as long as the premiums have been paid.

Automatic Premium Loan Rider: Allows the insurance company to deduct overdue premium from an insured's cash value **by the end of the grace period** if a payment is missed on a life policy.

Life Insurance Premiums, Proceeds and Beneficiaries

➢ PRIMARY FACTORS IN PREMIUM CALCULATIONS

Once an insurance company determines that an applicant is insurable, they need to establish the payment (premium) for the insurance policy.

Life insurance premiums are calculated based on the following three primary factors:

1. Mortality Factor

2. Interest Factor

3. Expense Factor

Mortality Factor: A measure of the number of deaths in a given population. Insurance companies use mortality tables to help predict the life expectancy and probability of death for a given group.

Interest Factor: Insurance companies invest the premiums they receive in an effort to earn interest. **The rate of earnings on investments** is one of the ways an insurance company can reduce premium rates.

Expense Factor: Insurance companies are just like any other business. They have operating expenses which need to be factored into the premiums. The expense factor is also known as the **loading charge.**

Other factors that impact the premium amount include:

- **Age:** The older the person, the higher probability of death and disability
- **Sex / Gender:** Women tend to live longer than men, so their premiums are usually lower
- **Health:** Poor health increases probability of death and disability
- **Occupation**: Hazardous job increases the risk of loss
- **Hobbies**: High risk hobbies also increase the risk of loss
- **Habits**: Tobacco use presents a higher risk than non-smokers

➢ Premium Payment Mode

Mode refers to the premium payment schedule and **permits the policyowner to select the timing of premium payments.** Insurance policy rates are based on the assumption that the premium will be paid annually at the beginning of the policy year and that the company will have the premium to invest (interest factor) for a full year. If the policyowner chooses to pay the premium more than once per year (example monthly, quarterly, semi-annually) there normally will be an additional charge because the company will have additional charges in billing and collecting the premium payments.

Premium Payment Options:

- Annual
- Semi-Annual
- Quarterly
- Monthly

Note: The higher the frequency of payments = higher premiums

Level Premium Funding: The policyowner pays more in the early years for protection to help cover the cost in later years, which allows the premiums to remain level throughout the life of the policy. **The shorter the premium-paying period , the higher the premiums, and vice versa.**

Reserves vs. Cash Value

Reserves: Money that together with future premiums, interest, and survivorship benefits will fulfill an insurance company's obligations to pay future claims.

Cash Value: Cash value applies to the savings element of whole life insurance policies that are payable before death. However, during the early years of a whole life insurance policy, the savings portion brings very little return compared to the premiums paid.

Tax Treatment of Premiums

Premiums paid on individual life insurance policies are generally not deductible.

Premiums for life insurance used for business purposes are generally not tax-deductible.

Here are the exceptions to these rules:

• Premiums used for a charity are tax-deductible.

• Life insurance premiums paid by an ex-spouse as court-ordered alimony are tax- deductible.

• Employer-paid premiums used to fund group life insurance for the benefit of employees are tax-deductible.

Tax Treatment of Cash Values

If cash value is surrendered, the portion that exceeds the premiums paid is taxable. For policies that are not surrendered, the cash value grows tax-free. As long as the cash value stays in the policy taxes will never be imposed on any portion, not even the amount that exceeds the cost basis.

➢ Policy Proceeds

Death Benefits: Death benefits are paid out in a variety of ways. These methods are known as settlement options. The policyowner may select a settlement option at the time of the application and may change the option at anytime during the life of the insured. Once selected, the settlement option cannot be changed by the beneficiary.

Death Benefit Settlement Options

- **Lump Sum:** Death benefit is paid in a single payment
- **Interest Only:** Insurance company holds death benefit for a period of time and pays only the interest earned to beneficiaries.
- **Fixed Period:** Also called period certain. The fixed period option is when the insurer pays proceeds (including interest and principal) in minimum guaranteed dollar payments over a specified number of years.
- **Fixed Amount:** The fixed amount installment option pays a fixed death benefit in specified installment amounts until the proceeds are exhausted. The larger the installment payment the shorter the payout period.
- **Life Income:** The life income option provides the beneficiary with an income that they cannot outlive. Installment payments are guaranteed for as long as the recipient lives, the amount of each installment is based on the recipient's life expectancy and the amount of principal. This gives the potential for a greater return, or the potential for greater loss, based on how long the insured lives
- **Joint and Survivor:** Benefits will be paid on a life-long basis to **two or more people**.

Living Benefits: A living benefit is the option to use some of the future death benefit proceeds when they may be most needed, before their death, when the insured has a terminal illness.

Living Benefit Options

- **Accelerated Benefit** – Allows someone that a physician certifies as terminally ill to access the death benefit. The amount of benefit received will be tax free.
- **Viatical Settlement** – Allows someone with a terminal illness to sell their existing life insurance policy to a third party for a **percentage of the death benefit**. The new owner continues to make the premium payments and will eventually collect the entire death benefit.

> **Note:** the original policyowner is called the Viator and the new third-party owner is called the Viatical, or sometimes referred to as the Viatee.

Tax Treatment of Proceeds

- Premiums: Not tax deductible
- Death Benefit: Tax- free if taken as a lump sum to a named beneficiary. Proceeds pass directly to the beneficiary and are **not subject to attachment by the insured's creditors**.
- Death Benefit Installments: Principal is tax- free – interest is taxable

Taxation of Proceeds Paid at Death

Life insurance proceeds paid to a beneficiary are usually tax free if taken as a lump sum. The exception to this rule is the **transfer for value rule**, which applies when a life insurance policy is sold to another party before the insured's death. Another tax cost typically associated with death is the **Federal estate tax** (although most relatively simple estates do not require the filing of an estate tax return).

Taxation of Proceeds Paid During the Insured's Lifetime

Policy Surrender: When a policy is surrendered for the cash value, some of the cash value received may be taxable, if the value was more than the amount of the premiums paid for the policy.

Accelerated Death Benefit: When benefits are paid under a life insurance policy to a terminally ill person, the benefits are received tax-free. To be considered terminally ill, a physician must certify that the person has a condition or illness that will result in death in two years.

> **Note**: Most states still require a Viatical company to inform the client that under a Viatical arrangement the proceeds could be taxable in certain situations and recommend they consult a tax advisor

1035 Exchange: Policy exchanges that qualify as a 1035 exchange are not taxable.

➢ BENEFICIARIES

Qualifications

There are very few restrictions on who may be named a beneficiary of a life insurance policy. The **policyowner** is the ultimate decision maker. However, in the underwriting process, the underwriter may consider the issue of insurable interest. When the policyowner lists themselves as the beneficiary, they will require proof of insurable interest.

Who can be beneficiaries?

- **Individuals**
- **Businesses**
- **Trust**
- **Estates**
- **Charities**
- **Minors**
- **Class (having a group named as the beneficiary instead, such as the children of the insured)**

Types of Beneficiaries

By Order of Succession:

- **Primary:** First in line to receive death benefit proceeds
- **Secondary (contingent):** Second in line to receive death benefit proceeds if primary beneficiary dies first
- **Tertiary:** Third in line to receive death benefit proceeds. If no one named, death benefit will go to insured's estate.

Distribution by Descent

- **Per Stirpes**: (meaning by the bloodline) In the event that a beneficiary dies before the insured, benefits from that policy will be paid to that beneficiary's heirs.
- **Per Capita**: (meaning by the head) Evenly distributes benefits among all named living beneficiaries.

Changing a Beneficiary

A policyowner may change the beneficiary at any time. There may be limitations, however.

- **Revocable Beneficiary** – **The policyowner may change the beneficiary at any time without notifying or getting permission from the beneficiary.**
- **Irrevocable Beneficiary** – **An irrevocable designation may not be changed without the written consent of the beneficiary.** The irrevocable beneficiary has a vested interest in the policy, therefore **the policyowner may not exercise certain rights (such as taking out a policy loan) without the consent of the beneficiary.**

Special Situations

- **Simultaneous Death**: If the insured and the primary beneficiary die at approximately the same time for a common accident with no clear evidence as to who died first, the **Uniform Simultaneous Death Act** law will assume that the primary died first, this allows the death benefit proceeds to be paid to the **contingent beneficiaries**.
- **Common Disaster Provision:** With a common disaster provision, a policyowner can be sure that if both the insured and the primary beneficiary die within a short period of time, **the death benefits will be paid to the contingent beneficiary.**
- **Spendthrift Clause:** Prevents a beneficiary from recklessly spending benefits by requiring the benefits to be paid in fixed amounts or installments over a certain period of time.
- **Facility of Payment:** allows the insurance company to pay all or part of proceeds to someone not named in the policy that has a valid right. This is usually done on behalf of a minor or when the named beneficiary is deceased.

Life Insurance Underwriting and Policy Issue

- **PURPOSE OF UNDERWRITING**

Underwriting is the process used by an insurance company to determine whether or not an applicant is insurable and if so, how much to charge for premiums. The underwriter will utilize several different types of information in determining the insurability of the individual. **This is called risk classification.** Material facts can affect an applicant being accepted or rejected.

- **UNDERWRITING PROCESS**

Application: The application is the starting point and basic source of information used by the insurance company in the risk selection. Although applications differ from company to company they all have the following same components. **Insurable interest must exist between the policyowner and insured at the time when the application is made.**

Application

Part I – General Information – Age, DOB, Sex, Address, Marital Status, Occupation

Part II – Medical Information – Health History

Part III – Agent's Report – Agent's personal observations of the applicant. Includes the applicant's financial condition, character, purpose of sale, and how long agent has known the applicant.

Credit Report: **An applicant's credit history is sometimes used for underwriting and to determine the likelihood of making premium payments.** The Fair Credit Reporting Act requires the applicant be notified in writing if a credit report will be used. The applicant must also be notified if the premium is increased because of a credit rating.

Warranty: Warranties are statements that are **guaranteed to be literally true.** A warranty that is not literally true in every detail, even if made in error, is sufficient to render a policy void.

Representation: Statements made by applicants that are substantially true to the best of their knowledge, but not warrantied as exact in every detail.

Medical Report: A medical report is sometimes used for underwriting policies with higher face amounts. If the information in the medical section warrants further investigation into the applicant's medical conditions, the underwriter may need an attending physician statement (APS).

Inspection Reports: This report provides information about the applicant's character, lifestyle, and financial stability. Inspection reports are usually only requested for larger coverages because they add expense to the underwriting process.

Medical Information Bureau (MIB): The MIB is a nonprofit trade organization which maintains medical information about individuals. Information from the MIB is used by life and health insurers. This helps insurance companies from adverse selection by applicants, as it detects misrepresentations, helps identify fraudulent information, and controls the cost of insurance. Information released from the Medical Information Bureau about a proposed insured may be released to the proposed insured's physician.

Special Questionnaires: are used for applicants involved in special circumstances, such as aviation, military service, or hazardous occupations or hobbies. The questionnaire provides details on how much of the applicant's time is spent in these activities.

Fair Credit Reporting Act: Regulates the way credit information is collected and used. Information regarding an individual's credit standing and general reputation is contained in a **consumer report**. **It established procedures for the collection and disclosure of information obtained on consumers through investigation and credit reports.** If an insurance company requests a credit report, the consumer must be notified in writing.

- The **producer** must provide a privacy notice to an applicant if personal information about that applicant is disclosed and is passed along to the insurer or its affiliates.
- **The applicant has the right to receive a copy of the report** when an investigative consumer report is used in connection with an insurance application.

➢ CLASSIFICATIONS OF RISK

After all necessary information is collected on an applicant the underwriter will classify the applicant based on the degree of risk assumed.

The following rating classification system is used to categorize the favorability of a given risk:

- **Preferred – Low Risk – Lower Premiums**
- **Standard - Average Risk – No Extra Ratings or Restrictions**
- **Substandard – High Risk – Rated Up – Higher Premiums**
- **Declined – Not Insurable – Potential of Loss to Insurance Company is Too High**

Lower risks tend to have lower premiums. Some of the following may result in a policy being issued with a preferred insurance premium:

- Applicant is nonsmoker and/or nondrinker
- Good personal/family health history

➢ FIELD UNDERWRITING PROCEDURES

Field underwriting is completed by the agent. Unlike the insurer, the agent has face-to-face contact with the applicant which can aid the insurer in risk selection. As field underwriters, agents help reduce the chance of adverse selection, assure that the application is filled out completely and correctly, collect the initial premium, and deliver the policy. Other duties include:

- Forwarding the application to the insurer in a timely manner
- Seeking additional information about the applicant's medical history if requested
- Notifying the insurer of any suspected misstatements in the application

Upon policy delivery, agents must deliver the life insurance buyer's guide and policy summary to the applicant. A life insurance producer may also be required to obtain a signature on a statement of good health at the time of policy delivery.

Buyer's Guide: provides general information about the types of life insurance policies available, in language that can be understood by the average person.

Policy Summary: provides specific information about the policy purchased, such as the premium and benefits.

Signatures: The agent and the applicant are required to sign the application. If the applicant is someone other than the proposed insured, except for a minor child, the proposed insured must also sign the application. This is considered third-party ownership.

In most states, once a minor reaches the age of 15, he is eligible to contract for an insurance policy.

Premiums and Receipts

Agents should make every effort to collect the initial premium with the application.

The agent issues the applicant a **premium receipt** upon collecting the initial premium.

There are two types of premium receipts that determine when coverage will begin. These are conditional receipts and binding receipts.

• **Conditional Receipt:** The producer issues a conditional receipt to the applicant when the application and premium are collected. **The conditional receipt denotes that coverage will be effective once certain conditions are met.** If the insurer accepts the coverage as applied for, the coverage will take effect from the date of the application or medical exam, whichever is later.

• **Binding Receipt:** The binding receipt or the temporary insurance agreement provides coverage from the date of the application regardless of whether the applicant is insurable. Coverage usually lasts for 30 to 60 days, or until the insurer accepts or declines the coverage. Binding receipts are rarely used in life insurance, and are primarily used in auto and homeowners insurance.

Effective Date of Coverage

As explained under conditional receipt, coverage is not effective without collection of the initial premium, approval of the application, and policy issuance and delivery. If the initial premium does not accompany the application, the premium must be collected by the agent. In some cases, the insurer requires the agent to collect a statement of good health from the insured at the time of delivery. If the initial premium is not submitted with the application, the policy effective date is established by insurer. In this case, it could be the date of policy issuance, or the date the policy is delivered to the applicant, premium collected, and statement of continued good health signed.

Backdating: is the process of predating the application a certain number of months to achieve a lower premium. A lower age results in a lower premium. A backdated application results in a backdated policy effective date, if approved by the insurer. Applications usually can only be backdated up to 6 months. This process is also known as "saves age".

Errors: If an agent realizes that an applicant has made an error on an application, the agent must correct the information and have **the applicant initial the changes**. **An incomplete application will be returned to the producer and a new one will have to be filled out.**

- **POLICY ISSUE AND DELIVERY**

The Statement of good health: verifies that the insured has not become ill, injured or disabled during the policy approval process (time between submitting application and delivery of the policy), or did not submit the initial premium with the application.

Personal delivery: of the policy is a good practice as it allows the producer to explain the coverage to the insured (such as the riders, provisions, and options). Personally delivering also builds trust and reinforces the need for the coverage. All of the following acts can be considered means of delivery: mailing policy to the agent; mailing the policy to applicant; and the agent personally delivering policy.

Group Life Insurance

➢ PRINCIPLES OF GROUP INSURANCE

Different from individual life insurance, which is written on a single life, group life insurance is written on more than one life. Group life insurance is usually written for employee-employer groups and is most often written as an annual renewable term policy. **An important underwriting principle of group life insurance is that all or a large percentage of persons in the group must be covered by the insurance.**

Contributory and Noncontributory Plans

Contributory – **An employee group plan in which employees share the cost.** Insurance company requires that at least 75% of all employees participate.

Noncontributory – **An employee group plan in which employees do NOT share in the cost.** Insurance company requires that 100% of all employees be eligible.

➢ FEATURES OF GROUP INSURANCE

The following are the two features that separate group insurance from individual insurance.

- the individual does not have to provide evidence of insurability- group underwriting is involved
- are not issued as individual policies- master contracts are issued instead
- low cost due to lower administrative, operational, and selling expenses associated with group plans
- flow of insureds: entering and exiting under the policy as they join and leave the group

  Note: Since the individual does not own or control the policy, they are issued a **certificate of insurance to prove they have coverage.** The actual policy, which is called the master policy, is issued to the employer.

  - Employees are called – **certificate holders**
  - Employers are called- contract holders

➢ ELIGIBLE GROUPS

Group life insurance can be formed by the following as well as other organizations, just as long as they are formed for a reason other than to purchase insurance. **There is no minimum # of members required for group life insurance.**

- **Single –employee groups**
- **Multiple-employee groups**
- **Labor Unions**
- **Trade Associations**
- **Credit/Debit groups**
- **Fraternal Organizations**

Eligibility of Group Members – (employees)

- **Employee must be full time and actively working**
- **If contributory, employees must approve of automatic payroll deduction**
- **New employee probationary period is usually 1 to 6 months**
- **The employee has 31 days during the enrollment period to sign up, otherwise they may need to provide evidence of insurability**

Types of Group Life Insurance Plans

Group Term Life: Life insurance is normally offered as a guaranteed annual renewable term policy. The policy is issued for one year and may be renewed annually without evidence of insurability at the discretion of the policyowner.

Group Whole Life: Though not as common, group whole life offers permanent protection for insured members under the group.

> **Note:** The most common types of Group Permanent (whole life) plans are: **Group Ordinary, Group Paid-Up, and Group Universal Life**

Dependent Coverage: Most group life insurance policies cover the member's dependents, as long as the amount of coverage does not exceed 50% of the insured member's coverage.

Taxation of Group Life Insurance Plans

For a group life insurance plan to receive favorable tax treatment, there are certain requirements in place. This makes sure that the average employee is not discriminated against in favor of higher level employees.

Determining eligibility: Must benefit at least 70% of all employees. At least 85% of all participating employees must not be key employees.

Premiums for group life insurance: If paid by the employee are not tax-deductible. However, if the employer pays, it can deduct the premiums it pays as a business expense. Proceeds from a group life policy are tax-free if taken in a lump-sum. Proceeds taken in installments will be subject to taxes on the interest portion of the installments.

How Benefits are Determined

Most employers will establish benefit schedules according to the following:

- **Earnings**
- **Employment position**
- **Flat benefit**

Conversion to Individual Policy: If a member's coverage is terminated, the member and his dependents may convert their group coverage to individual whole life coverage, **without having to show proof of insurability.**

Conversion Period: An individual must apply for individual coverage within 31 days after the date of group coverage termination. **An individual is covered under the group policy during the conversion period.**

Group Policy Termination: If the master policy is terminated, each individual member who has been insured for at least 5 years is permitted to convert to an individual policy, providing coverage up to the face value of the group policy.

➢ OTHER FORMS OF GROUP LIFE INSURANCE

The following are other types of life insurance issued as group plans:

Franchise Life Insurance: This is used where participants are employees of a common employer (i.e., the employer may operate several companies) or are members of a common association or society. The employer/association/society is a sponsor of the plan and may or may not contribute to the premium payments. Unlike the employer's group plan, each individual will be issued an individual policy which will remain in force as long as premiums are paid and the employee/member maintains their relationship with the sponsor. These are used by small groups who individually do not meet the state's minimum numbers required by law.

Group Credit Life: These are set-up by banks, finance companies, etc. in case the insured dies before a loan is repaid. Policy benefits are paid to the creditor and used to settle the loan balance. The premiums are usually paid by the borrower. A **decreasing term policy** is commonly used.

Blanket Life Insurance: Covers groups of people exposed to the same hazard, such as passengers on an airplane. No one is named on the policy and there is not a certificate of coverage given out. Individuals are only covered for the common hazard.

Group Permanent Life: Some group life plans are permanent (whole life) plans, using some form of permanent or whole life insurance as the underlying policy. The most common types of permanent group plans are group ordinary, group paid-up, and group universal life.

Annuities

➢ PURPOSE AND FUNCTION

While life insurance protects against the risk of premature death, **annuities protect against the risk of living too long.**

Annuity Basics

Annuities: are ways of providing a stream of income for a guaranteed period of time.

- Simply stated, an annuity is started with a large sum of money that will be paid out in installments over a period of time or until the money is all gone.
- The monthly amount of benefit an annuitant receives is based on factors such as: principle amount, rate of interest the annuity earns, and length of payout period.

Contract owner: The individual who purchases the annuity pays the premiums and has rights of ownership.

- An owner may be the annuitant, the beneficiary, or neither

Annuitant: The income benefits distributed at regular intervals during the liquidation phase of an annuity contract are normally payable to the **annuitant.**

Beneficiary: The beneficiary is the person who receives survivor benefits upon the annuitant's death.

Accumulation Period vs. Annuity Period

Most annuities have two phases, the accumulation period and the annuity period.

- **Accumulation Period:** The pay-in period, where the contract owner makes the purchase payments. The accumulation period of an annuity normally may continue after the purchase payments cease.

- **Annuity Period:** This is also called the liquidation period, annuitization period, or pay-out period. This is the time when the money that has accrued during the accumulation period is paid-out in the form of payments to the annuitant.

➢ STRUCTURE AND DESIGN

Funding Method

- Single Payment – Lump Sum
- Periodic Payments - Installments paid over a period of time

Date Income Payments Begin

Immediate Annuities: **Purchased with a single lump sum payment, and will start providing income payments within the first year, but usually starting 30 days from the purchase date.** It's purpose is to provide for liquidation of a principle sum. J

- Commonly used to structure the payment of liability insurance settlements, lottery winnings, and other large sums

- This type of annuity is usually called a **Single Premium Immediate Annuity** (SPIA)

Deferred Annuities: will start providing income payments after the first year. Deferred annuities are usually purchased with either a single lump sum payment known as **a Single Premium Deferred Annuity** (SPDA) or from monthly payments known as **Flexible Premium Deferred Annuity** (FPDA). A Fixed Deferred Annuity, for example, pays out a fixed amount for life starting at a future date. **Interest credited to the cash values of annuities are deferred until distribution.** Other characteristics of deferred annuities include:

- When a deferred annuity is cancelled during the early contract years, the insurer normally will assess a back-end load known as a **surrender charge**
- The **"bailout"** feature, sometimes found in single premium deferred annuity contracts, waives surrender charges when the interest rate falls below a stated level
- Before a deferred annuity contract can be terminated for its surrender value, the insurer must first obtain authorization from the **owner**
- **The accumulation value of a deferred annuity is equal to the sum of premium paid plus interest earned minus expenses and withdrawals**

➢ PAY OUT OPTIONS

Straight Life Income Payout Option: pays the annuitant a guaranteed income for the annuitant's lifetime. When the annuitant dies, no further payments are made to anyone. This offers protection against **exhaustion of savings due to longevity**.

Cash Refund Payout Option: Pays a guaranteed income to the annuitant for life. If the annuitant dies before all the money is gone, a lump-sum cash payment of the remaining funds are paid out to the annuitant's beneficiary.

Installment Refund Payout Option: Pays a guaranteed income to the annuitant for life. If the annuitant dies before the money is gone, the beneficiary will continue to receive the same monthly installment payments.

Life with Period Certain Payout Option (life income with term certain): is designed to pay the annuitant guaranteed payments for the life of the annuitant or for a specific period of time for the beneficiary. It provides that benefit payments will continue for a minimum number of years regardless of when the annuitant dies.

- For example, if an annuitant has a 20 year period certain and dies after 10 years, the beneficiary will receive payments for another 10 years.

Joint and Full Survivor Payout Option: Pays out the annuity to two or more people **until the last annuitant dies.** If one of them dies, the other will continue to receive the same income payments. There are two additional options made available with a joint and survivor payout:

- **Joint and two-thirds survivor:** Survivor will have payments reduced to two-thirds of the original payment.
- **Joint and one-half survivor:** Survivor will have payments reduced to one-half of the original payment.

Period Certain Payout Option: Pays guaranteed income payments for a certain period of time, such as 10 or 20 years, whether or not the annuitant is living.

INVESTMENT CONFIGURATION

Annuities can also be defined by their investment configuration, which will determine the amount of income the benefits pay. The two types of annuity classifications are fixed annuities and variable annuities.

Fixed Annuity: Provide a guaranteed rate of return. Fixed annuities credit interest at a rate no lower than the **contract guaranteed rate.**

Variable Annuity: Does not provide a guaranteed rate of return, because of the investment risk. **The cash value is based on the results of these investment funds.** A statement must be provided to the owner of the annuity at a minimum of once per year. Variable annuities can be classified as either immediate or deferred. Insurers that deal with variable annuities are subject to dual regulation by the SEC and the state's Office of Insurance Regulation.

- **Accumulation Units:** In a variable annuity, the value of the accumulation units varies depending on the value of the stock investment that is a part of a variable annuity.
- **Annuity Units:** At the time the variable annuity is to be paid out to the annuitant, the accumulations are converted into annuity units. These payouts can vary from month to month depending on the investment results. The number of units doesn't change, but the value does. The amount of each variable annuity benefit paid to an annuitant varies according to the market value of the securities backing it.

Equity Indexed Annuities: A type of fixed annuity that offers the potential for a higher return than a standard fixed annuity. They are sometimes tied to the Standard and Poor's 500 or the Composite Stock Price Index.

Single-life annuities: Characterized by having only one annuitant.

Tax-sheltered annuities: Limited exclusively for employees of religious, charity, or educational groups.

- Also called 403(b) plans
- Accumulation payments often come from voluntary salary reductions
- The annuitant may have an individual account contract

Income Tax Treatment of Annuity Benefits: Annuity benefit payments consist of principal and interest. The portion of annuity benefits that consists of principal (premiums paid into the annuity during the accumulation period) are not taxed and is sometimes called the owner's **"cost basis"**. The portion of the annuity benefits that is interest earned on the principal is taxable as ordinary income. Interest income must be reported for federal income tax purposes **upon receiving distributions or income benefits from the contract.**

- **The exclusion ratio** is a simple way to determine what portion of each annuity benefit payment is taxable:
  Exclusion ratio = Investment in the contract / Expected return

Partial Withdrawal: is taken from an annuity before age 59 ½ the withdrawal is considered 100% interest, and is therefore taxable as ordinary income.

A 10% tax penalty is applied if a distribution is received before the annuitant reaches age 59 ½.

After this age, withdrawals do not incur the 10% penalty tax, but are taxable as ordinary income.

1035 Exchange: applies to annuities. If an annuity is exchanged for another annuity, a gain (for tax purposes) is not realized. This is also true for a life insurance policy or an endowment contract exchanged for an annuity. However, an annuity cannot be exchanged for a life insurance policy.

➢ SUITABILITY OF ANNUITY SALES FOR SENIOR CUSTOMERS

Senior Residents Age 65 or Older

When making recommendations to a senior consumer regarding the purchase or exchange of an annuity, an agent must have reasonable grounds for believing that this **recommendation is suitable for the senior consumer.** This recommendation should be based on the facts disclosed by the senior consumer. It should include an evaluation of his investments and other insurance products along with his financial situation and needs.

Social Security

➢ PURPOSE

Social Security, also known as Old Age, Survivors, and Disability Insurance (OASDI), was signed into law in 1935 by President Roosevelt as part of the Social Security Act. Social Security was established during the Great Depression to assist the masses of people who could not afford to sustain their way of life because of unemployment, disability, illness, old age, or death.

➢ WHO IS COVERED

Social Security extends coverage to virtually every American who is employed or self-employed, with few exceptions. Those not covered include:

- Most federal employees hired before 1984 who are covered by Civil Service Retirement or another similar plan
- Approximately 25% of state and local government employees who are covered by a state pension program and elect not to participate in the Social Security Program
- Railroad workers covered under a separate federal program called the Railroad Retirement System

➢ HOW BENEFITS ARE DETERMINED

A person must be insured under the Social Security program in order for survivors, disability, or retirement benefits to pay. Social Security benefits are based on how long a covered worker has worked throughout his life.

Insured Status

Social Security establishes benefit eligibility based on an "insured" status. There are two types of insured statuses that qualify individuals for Social Security benefits: fully insured and currently insured. Most Social Security benefits are paid to fully-insured individuals.

Fully Insured and Currently Insured

<u>To obtain **fully insured status**, a covered worker must accrue a total of 40 quarters of credit, which is about 10 years of work. To be considered **currently insured**, and thus eligible for limited survivor benefits, a worker must have earned 6 credits during the last 13-quarter period.</u>

Social Security Payroll Taxes

Funding for Social Security is collected from FICA payroll taxes. Social Security payroll taxes are collected from employers, employees, and self-employed individuals. FICA tax is applied to an employee's income up to a certain income amount. This amount is called the taxable wage base. There is a maximum amount of earnings that can be subject to Social Security tax each year. This amount is indexed each year to the national average wage index. This maximum applies to employers, employees, and self-employed individuals. Medicare Part A taxes are not subject to a maximum taxable wage cap.

Taxation of Social Security Benefits

Social Security benefits are subject to federal income tax if the beneficiary files an individual tax return and his annual income is greater than $25,000. Joint filers will pay federal income tax on their Social Security benefits if their income is greater than $32,000.

Calculating Benefits

The amount of Social Security benefits a person receives is based on the individual's average monthly wage during his working years. The primary insurance amount (PIA) is used to establish the benefit. It is equal to the worker's full retirement benefit at age 65. If a worker retires early, for example at age 62, his retirement benefits will be 80% of his PIA and will remain lower for the covered worker's life. The PIA is based on the average earnings over your lifetime.

- **TYPES OF OASDI BENEFITS**

Survivors Benefits

Social Security Survivors benefits or death benefits: pay a lump-sum death benefit or monthly income to survivors of deceased covered workers.

Survivor's benefits: include a $255 lump-sum death benefit, surviving spouse benefits, child's benefit, and parent's benefit.

Disability Benefits

Social Security Disability Benefits: are only available to covered workers **who are fully insured,as defined by Social Security,** at the time of disability. Disability income benefits are paid to the covered worker in the amount of the PIA after a **5-month** waiting period. Social Security disability benefits are only available prior to the age of 65. Social Security does not pay partial disability or short-term disability benefits. The disability must be total and expected to last 12 months or end in death. Benefits include monthly payments to the disabled worker, spousal benefits, and child's benefits.

Definition of Disability: In order to be considered totally disabled, an individual has to qualify according the following requirements:

- The inability to engage in any gainful work that exists in the national economy
- The disability must result from a medically determinable physical or mental impairment that is expected to result in early death, or has lasted, or is expected to last for a continuous period of 12 months

Retirement Benefits

Social Security retirement benefits are only available to covered workers who are fully insured upon retirement. Benefits are paid monthly. If a covered worker retires at the normal retirement age, he will receive 100% of the PIA. However, if a covered worker retires early at the age of 62, the maximum Social Security benefit is 80% of the PIA. This reduction remains all through retirement. Retirement benefits pay covered retired workers at least 62 years of age, their spouses and other eligible dependents monthly retirement income. Retirement benefits include monthly retirement payments to the covered worker, spousal benefits, and child's benefits.

Black-Out Period

This refers to benefits paid to the surviving spouse of a deceased person who was receiving Social Security. The "black-out period" begins when Social Security survivorship benefits cease. This is when the youngest child turns 16 years old, or if no children- immediately. The "black-out period" ends when the surviving spouse turns at least 60 years old.

Retirement Plans

➢ QUALIFIED PLANS VERSUS NONQUALIFIED PLANS

Qualified plans are retirement plans that meet federal requirements and receive favorable tax treatment. Qualified plans provide tax benefits and must be approved by the IRS. The plans must be permanent, in writing, communicated to employees, defined contributions or benefits, and cannot favor highly paid employees, executives, or stockholders. The primary type of qualified plans includes defined benefit and defined contribution plans.

- To comply with ERISA minimum participation standards, qualified retirement plans must allow the enrollment of all employees over age 21 with one year experience.
- If more than 60% of a qualified retirement plan's assets are in key employee accounts, the plan is considered **"top heavy".**

Qualified plans have the following features:

- Employer's contributions are tax-deductible as a business expense.
- Employee contributions are made with pretax dollars – contributions are not taxed until withdrawn.
- Interest earned on contributions is tax-deferred until withdrawn upon retirement
- The annual addition to an employee's account in a qualified retirement plan cannot exceed the maximum limits set by the Internal Revenue Service

Nonqualified plans are characterized by the following:

- Do not need to be approved by the IRS
- Can discriminate in favor of certain employees
- Contributions are not tax-deductible
- Interest earned on contributions is tax-deferred until withdrawn upon retirement

Tax Benefits of Qualified Plans

Employer's contributions are tax-deductible and not treated as taxable income to the employee. Employee contributions are made with pre-tax dollars, and any interest earned on both employer and employee contributions are tax-deferred. Employees only pay taxes on amounts at the time of withdrawal.

Withdrawals and Taxation

Withdrawals by the employee are treated as **taxable income**. Withdrawals by the employee made prior to age 59 ½ are assessed an additional **10% penalty tax**. Distributions are mandatory by April 1st of the year following **age 70½,** and failure to take the required withdrawal results in a **50% excise tax** on those funds.

Funds may be withdrawn prior to the employee reaching age 59 ½ without the 10% penalty tax: if the employee dies or becomes disabled; if a loan is taken on the plan's proceeds; if the withdrawal is the result of a divorce proceeding; if the withdrawal is made to a qualified rollover plan; or if the employee elects to receive annual level payments for the remainder of his life.

The Employee Retirement Income Security Act of 1974 (ERISA)

ERISA was enacted to provide minimum benefit standards for pension and employee benefits plans, including fiduciary responsibility, reporting and disclosure practices, and vesting rules. The overall purpose of ERISA is to protect the rights of workers covered under an employer-sponsored plan.

- **EMPLOYER-SPONSORED PLANS**

Defined Benefit Plans

Defined benefit plans pay a specified benefit amount upon the employee's retirement. When the term pension is used, it normally is referring to a defined benefit plan. The benefit is based on the employee's length of service and/or earnings. Defined benefit plans are mostly funded by individual and group deferred annuities.

Defined Contribution Plans

Defined contribution plans do not specify the exact benefit amount until distribution begins. Two main types of plans are profit-sharing and pension plans. The maximum contribution is the lesser of the employee's earnings or $49,000 per year. Here are some examples of defined contribution plans:

Profit-Sharing Plans
A type of retirement plan that sets aside a portion of the firm's net income for distributions to employees who qualify under the plan. Plans must provide participants with the formula the employer uses for contributions. The contributions may vary year to year, and contributions and interest are tax-deferred until withdrawal.

Pension Plans
Employers contribute to a plan based on the employee's compensation and years of service, not company profitability or performance.

Money Purchase Plans
Allow employers to contribute a fixed annual amount, apportioned to each participant, with benefits based on funds in the account upon retirement. *Target benefit plans* have a target benefit amount.

Stock Bonus Plans
These plans are similar to a profit-sharing plan, except that contributions by the employer do not depend on profits, and benefits are distributed in the form of company stock.

Other Employer-Sponsored Plans

Cash or Deferred Arrangement (401(k) Plans)
401(k) plans allow employers to make tax-deferred contributions to the participant, either by placing a cash bonus into the employee's account on a pre-tax basis or the individual taking a reduced salary with the reduction placed pre-tax in the account. The account's funds are taxable upon withdrawal.

Tax-Sheltered Annuity (403(b) Plans)
Tax-sheltered annuities are a special class of retirement plans available to employees of certain charitable, educational, or religious organizations.

- ## QUALIFIED PLANS FOR SMALL EMPLOYERS

Simplified Employee Plans (SEPs)
SEP's are basically an arrangement where an employee (including a self-employed individual) establishes and maintains an IRA to which the employer contributes. Employer contributions are not included in the employee's gross income. A primary difference between a SEP and an IRA is the much larger amount that can be contributed to an employee's SEP plan is the lesser of 25% of the employee's annual compensation.

Savings Incentive Match Plan for Employees (SIMPLE)
SIMPLE plans are available to small businesses (including tax exempt and government entities) that employ **no more than 100 employees who received at least $5,000 in compensation from the employer during the previous year**. An employer can choose to make nonelective contributions of 2% of compensation on behalf of each eligible employee. To establish a SIMPLE plan, the employer must not have a qualified plan in place.

Keogh Plans
Keogh or HR-10 plans are for self-employed persons, such as doctors, farmers, lawyers, or other sole-proprietors. Keoghs may be defined contribution or defined benefit plans. Defined contribution Keoghs have a maximum contribution of $49,000 per year, while defined benefit Keoghs have maximum benefits of $195,000 per year. Contributions are tax-deductible, and interest and dividends are tax-deferred.

- ## INDIVIDUAL RETIREMENT PLANS

IRAs are established by an individual who has earned income to save for retirement.

Traditional IRAs
Traditional IRAs allow for an individual to contribute a limited amount of money per year, and the interest earned is tax-deferred until withdrawal. Contribution limits are indexed annually, currently at $5,000 per year, with $6,000 for individuals age 50 or older. Some individuals may deduct contributions from their taxes based on their adjusted gross income (AGI), but all withdrawals are taxable income. If an individual or spouse does not have an employer retirement plan, the entire contribution is tax-deductible, regardless of AGI. **Withdrawals made prior to age 59 ½ are assessed an additional 10% penalty tax.**

To avoid penalties, traditional IRA owners must begin to receive payment from their accounts no later than April 1 in the year following the attainment of age 70 ½. Funds may be withdrawn prior to the employee reaching age 59 ½ without paying the 10% penalty tax (but the interest is still taxable) to the following: death, disability, first-time homebuyers up to $10,000, education (no dollar maximum), health insurance premiums if unemployed, qualified medical expenses.

Roth IRAs

Roth IRAs are designed so that withdrawals are received **income tax-free**. Contributions to Roth IRAs are subject to the same limits as traditional IRAs, but are not tax-deductible. Interest on contributions is not taxable as long as the withdrawal is a qualified distribution. *Qualified distributions* must occur after five years in the event of death or disability of the individual, up to $10,000 for first-time homebuyers, or at the age of 59 ½.

Rollovers

Rollovers are a transfer of funds from one IRA or qualified plan to another.

- Rollovers are subjected to **20% withholding tax** if eligible rollover funds are **received personally by a participant** in a qualified plan, unless the funds are deposited into a new IRA or qualified plan within 60 days of distribution.
- Funds that are transferred directly from one qualified IRA to another qualified IRA are not subject to this withholding tax. This also includes a trustee-to-trustee transfer of rollover funds instead of personally receiving the funds and then rolling them over. This election permits the participant to avoid mandatory income tax withholding on the amount transferred.
- A surviving spouse who inherits IRA benefits from a deceased spouse's qualified plan is eligible to establish a rollover IRA in their own name.
- Rollover contributions to an individual retirement annuity (IRA) are unlimited by dollar amount

➢ FEDERAL PENSION ACT OF 2006

This law sets forth standards for funding, participating, vesting, disclosure, and tax treatment of retirement plans.

- This Act improves the pension system and encourages employees to increase contributions to their employer-sponsored retirement plans. The provisions of the act have two main goals: addressing employers pension funds and assisting employees who are saving for retirement.

- It addresses employer responsibilities by requiring additional premiums for underfunded plans. It does this by requiring employers to obtain accurate assessments of the pension's financial obligations. It also closes loopholes by which underfunded plans skip payments and prevents employers with under-funded plans from promising extra benefits without first funding those benefits.

- It helps employees who save for retirement through qualified plans by: allowing employers to automatically enroll employees in defined compensation plans; provide more accurate information about accounts; increase access to professional advice about investments; allow for direct deposit of income tax refunds into IRA's; allow active military to make early penalty-free withdrawals; increase limits on contributions to all qualified plans; and provide for better portability for those plans.

➢ 1035 EXCHANGES

All of the following are types of insurance policy exchanges that can be made without current taxation:

- The exchange of a life insurance policy for an annuity
- An annuity exchanged for another annuity contract
- A life insurance policy exchanged for another life policy

<u>The exchange of an annuity for a life insurance policy is NOT permitted</u>

Uses of Life Insurance

➢ DETERMINING THE PROPER INSURANCE AMOUNTS

1. **Human Life Value Approach:** Calculates the amount of money a person is expected to earn over his lifetime to determine the face amount of life insurance needed, thereby placing a dollar value on the life of an individual.

2. **Needs Approach:** A method of life insurance planning which **identifies the needs of an individual and the individual's dependents.** This approach determines the total funds available to a family from all sources and subtracts the amount needed to meet their financial objectives. It takes into consideration:

- **Final Expense Fund**
- **Housing Fund**
- **Education Fund**
- **Monthly Income**
- **Emergency Fund**
- **Income Needs if Disabled or Ill**
- **Retirement Income**

➢ BUSINESS USES OF LIFE INSURANCE

Buy-Sell agreements are also known as business continuation agreements and are used to assure the ownership of the business is properly transferred upon the death or disability of an owner or partner. **Third-party ownership of life insurance policies is widely used in business insurance and estate-planning situations.**

Buy-Sell Funding for Sole Proprietors
There is a two-step business continuation plan to keep the business running after the proprietor's death, whereby the employee takes over management of the business:

- **Buy-Sell Plan:** an attorney drafts a buy-sell plan stating the employee's agreement to purchase the proprietor's estate and sell the business at a price that has been agreed-upon beforehand.

- **Insurance Policy:** the employee purchases a life insurance policy on the life of the proprietor. The employee is the policyowner, beneficiary, and pays the premiums. Upon the proprietor's death, the funds from the policy are used to buy the business.

Buy-Sell Funding for Partnerships

There are two types of buy-sell agreements for partnerships: cross-purchase plans and entity plans.

Cross-purchase plans: In a cross-purchase plan, each partner buys, pays the premiums, and is the beneficiary of a life insurance policy on each of the other partners. The amount of the policy is equivalent to each partner's share of the business. When one partner dies, each of the other partners receives the death benefit from the life insurance on the deceased partner, which is then used to buy the deceased partner's ownership of the business.

Entity plans: the partnership itself agrees to buy the deceased partner's share of the business. Entity plans are best for businesses with several partners. In this case, the business purchases, pays the premiums and is the beneficiary of life insurance on each partner.

Buy-Sell Funding for Close Corporations
Unlike a partnership, a close corporation (i.e. an incorporated family business) is legally separate from its owners. It exists after one or more owners dies. A close corporation may purchase either buy-sell plans: cross-purchase or entity. The difference is that an entity plan is termed a *stock redemption plan* for close corporations.

Close Corporation Cross-Purchase Plan
Similar to partnership cross-purchase plans, a close corporation cross-purchase plan requires surviving stockholders purchase the deceased stockholder's interest in the company, and the deceased stockholder's estate sell the interest to the surviving stockholders. The corporation is not part of the buy-sell plan. Each stockholder owns, pays the premiums and is the beneficiary of life insurance on each of the other stockholders in an amount equal to his share of the corporation's purchase price.

Close Corporation Stock Redemption Plan
Similar to the partnership entity plan, the corporation purchases, is the owner, pays the premiums and is the beneficiary of life insurance policies on each stockholder. The amount of life insurance is equal to each stockholder's share of the corporation's purchase price. When a stockholder dies, the corporation purchases, or redeems, the deceased stockholder's share.

Key Person Insurance: The purpose of key person insurance is to prevent the financial loss that may ensue when an owner, officer or manager dies.

- It pays for finding and training a replacement if the key employee dies prematurely
- The company purchases, owns, pays the premiums and is the beneficiary of the life insurance policy on the key person.
- The premiums are not deductible for income purposes. However, the death proceeds received by the business are not taxable.

➢ EMPLOYEE BENEFIT PLANS

Deferred Compensation: is an executive benefit an employer can use to pay a highly paid employee at a later date, such as upon disability, retirement or death.

Salary Continuation Plan: works the same as deferred compensation except that the employer funds the plan rather than the employee. The employer establishes an agreement, whereby an employee will continue to receive income payments upon death, disability or retirement.

Split-Dollar Plan: is an arrangement where an employer and an employee share in the cost of purchasing a life insurance policy on the employee. It is a method of buying insurance, not an insurance policy itself. Many times it is a combination of term and whole life insurance.