LIFE INSURANCE
And
ANNUITIES
Fundamentals

SANDI KRUISE INSURANCE TRAINING
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The following chart summarizes and compares the characteristics, markets, advantages and disadvantages, and other features of various types of life and annuity contracts you will be studying in this course.

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<th>PRODUCT</th>
<th>CHARACTERISTICS</th>
<th>MARKET</th>
<th>DEATH BENEFIT</th>
<th>PREMIUM</th>
<th>CASH VALUE (CV)</th>
<th>CV AND/OR DIVIDENDS USE CURRENT INTEREST?</th>
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<td>Annual Renewable Term</td>
<td>“Pure” life insurance with no cash value element; initially, the highest death benefit for the lowest premium.</td>
<td>Short to intermediate term need; need max. Death benefit for min. initial premium.</td>
<td>Fixed, level</td>
<td>Fixed, increasing</td>
<td>No cash value</td>
<td>N/A</td>
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<td>Participating Ordinary Life</td>
<td>Most common and easily understood form of lifetime coverage; known max cost and min death benefit levels; dividends may reduce premiums, pay-up policy, buy paid-up additions, accumulate at interest, be paid in cash.</td>
<td>Anybody who needs lifetime coverage.</td>
<td>Fixed, level</td>
<td>Fixed, level</td>
<td>Fixed with min guaranteed interest rate; excess through dividends.</td>
<td>Yes</td>
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<tr>
<td>Current Assumption Whole Life</td>
<td>Mixes characteristics of universal life and traditional ordinary life; future premiums, face amount, and/or cash value based on interest, expense, mortality experience.</td>
<td>Upper and middle income prospects.</td>
<td>Fixed, level</td>
<td>May change based on insurer's experience; max guaranteed but insurer may charge less.</td>
<td>May change based on insurer's experience; guaranteed min; min guaranteed interest; excess lowers premium or increases CV.</td>
<td>Yes</td>
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<td>Variable Life</td>
<td>Whole life contract with assets supporting policy held in separate account; choice of investment</td>
<td>Upper and middle income prospects with investment acumen.</td>
<td>Guaranteed min; can increase based on investment performance.</td>
<td>Fixed, level</td>
<td>Based on investment performance; not guaranteed.</td>
<td>N/A</td>
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assets; death benefits depend on investment results.

### Adjustable Life
May select death benefit and, within limits, choose premiums; face amount and premiums are fixed between adjustment periods; usual features of whole life.

Young families starting insurance program; need for flexibility with guarantees.

Adjustable

Adjustable at option of policyowner.

Varies depending on premium/death benefit mix; fixed with min guaranteed interest; excess through dividends.

Yes

### Universal Life
Flexible premium current-assumption adjustable death benefit policy; policy elements unbundled; two death benefit options.

Middle and upper income looking for ultimate in flexibility.

Adjustable’ Option A life Ord. Life’ Option B life Ord. Life plus term rider equal to cash value.

Flexible at option of policyowner.

Varies depending on face amount and premium; min guaranteed interest excess interest increases cash value.

Yes

### Universal Variable Life
Combines features of universal and variable life.

Middle and upper income with investment acumen looking for ultimate in flexibility.

Adjustable

Flexible at option of policyowner.

Varies depending on face amount, premium, and investment performance; not guaranteed.

N/A

### Annuities
Combine tax advantages, investment choice, flexibility and guarantees with various lifetime payout options that cannot be outlived.

Middle and upper income; qualified (IRA) and non-qualified retirement arrangements.

Accumulation period: max of premiums or cash value; payout period: depends on option.

Fixed or flexible

Varies depending on investment performance; min guaranteed interest rate unless variable annuity.

Yes

### PRODUCT PARTIAL SURRENDER PERMITTED? POLICY ELEMENTS DIRECT BORROWING RECOGNITION ADVANTAGE TO BUYER DISADVANTAGE TO BUYER RISKS TO BUYER

<table>
<thead>
<tr>
<th>PRODUCT</th>
<th>PARTIAL SURRENDER PERMITTED</th>
<th>POLICY ELEMENTS</th>
<th>DIRECT BORROWING RECOGNITION</th>
<th>ADVANTAGE TO BUYER</th>
<th>DISADVANTAGE TO BUYER</th>
<th>RISKS TO BUYER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Renewable Term</td>
<td>N/A</td>
<td>Bundled</td>
<td>N/A</td>
<td>Low outlay for large face amounts; develop outside investment program.</td>
<td>Increasing outlay; buyer may not invest difference or may realize lower return.</td>
<td>Increasing premium. Failure to earn more after tax on investments than insurer.</td>
</tr>
<tr>
<td>Participating Ordinary Life</td>
<td>Yes, but through paid up additions only.</td>
<td>Bundled</td>
<td>Yes, with many policies.</td>
<td>Familiar product; predictable; helps buyer discipline;</td>
<td>Costly if lapsed early.</td>
<td>Failure to meet premium commitment.</td>
</tr>
<tr>
<td>Product Type</td>
<td>Current Assumption</td>
<td>Bundled/Unbundled</td>
<td>Flexibility</td>
<td>Investment Risk</td>
<td>Long-Term Considerations</td>
<td></td>
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<tr>
<td>Whole Life</td>
<td>Yes</td>
<td>Unbundled</td>
<td>Yes</td>
<td>Yes</td>
<td>Id assumptions change adversely, premiums can be higher or cash value can be lower than with traditional products.</td>
<td></td>
</tr>
<tr>
<td>Current Interest</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Variable Life</td>
<td>No</td>
<td>Bundled, but to some degree shown in prospectus.</td>
<td>No</td>
<td>Take advantage of growth in economy.</td>
<td>Investment risk is great. Typically higher expenses than traditional products.</td>
<td></td>
</tr>
<tr>
<td>Adjustable Life</td>
<td>Yes</td>
<td>Bundled</td>
<td>Yes</td>
<td>Flexibility to adjust to changing needs; only one policy needed.</td>
<td>Changes made by buyer to satisfy short-term needs may have an impact on the satisfaction of long-term goals.</td>
<td></td>
</tr>
<tr>
<td>Universal Life</td>
<td>Yes</td>
<td>Unbundled</td>
<td>Yes</td>
<td>Greater transparency and more flexibility than Adj. Life</td>
<td>Adverse change in assumptions can affect satisfaction of long-term goals and drop cash value below that of ordinary life.</td>
<td></td>
</tr>
<tr>
<td>Universal Variable Life</td>
<td>Yes</td>
<td>Unbundled</td>
<td>No</td>
<td>Epitome of flexibility in all respects.</td>
<td>Combined risks of universal and variable life products.</td>
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</tr>
<tr>
<td>Annuities</td>
<td>Yes</td>
<td>Partially unbundled</td>
<td>Yes, if permitted.</td>
<td>Cannot outlive benefits if life option elected.</td>
<td>Under life options, payouts cease at death: if death occurs early, total benefits less than with alternative investments.</td>
<td></td>
</tr>
</tbody>
</table>
LIFE INSURANCE

Life insurance plays an important role in the financial security of many families. More than 80% of American households have purchased individual life insurance policies. Over the years, life insurance policies have evolved from contracts that only provided death benefits into complex contracts that often include numerous types of benefits and features. New products have frequently been introduced in response to changing economic conditions and consumer preferences, and that trend is expected to continue in the future.

This course will examine the field of life insurance, including the role of underwriting and rating, types of policies in the marketplace, life insurance riders, policy options, policy provisions, and some of the ways that life insurance is used in financial planning.

THE USES OF LIFE INSURANCE

Life insurance is primarily used to function in personal and family situations. As a rule a person's death creates an immediate need for money. The following is a list of some of the needs that might be created from an individual's death.

- Expenses created by final illness.
- Burial and funeral expenses.
- Debts due at time of death.
- Costs to administer the estate.
- Federal and state death taxes.
- Inheritance taxes.

Money may also be needed to provide for the following:

- Payoff mortgage or purchase a new home.
- Provide an education for children.
- Meet unexpected financial needs.

Life insurance can also provide benefits for business situations. Here are a few examples:

- Loss caused by death of a key employee.
- Collateral for loans.
- A business insurance fund.
- Buy-out business interest of a deceased owner.

- Fringe benefits for employees.
- Fund qualified retirement plans.

REASONS FOR BUYING LIFE INSURANCE – PERSONAL LOSS EXPOSURES

A personal loss exposure can be defined as any condition or situation that presents the possibility of a direct financial loss to a human being. Certain personal loss exposures can result in great financial difficulty for individuals and their family members. Important personal loss exposures include premature death, poor health, unemployment, and insufficient income during retirement. Personal loss exposures can be reduced or even eliminated by life and health insurance, disability income insurance, private and public retirement plans, and an effective saving and investing program.

When selling life insurance, agents should assist applicants in determining the types and amounts of coverage to purchase. While consumers are usually aware of a general need for life insurance, many of them may not be aware of the full range of their needs for coverage.

Death Benefits

Death benefits are the one thing that all types of life insurance contracts have in common. In the purest sense, life insurance is a contract that pays a death benefit to someone when an insured person dies. This concept is easily understood. We buy fire insurance to protect against the risk of fire damage, we buy flood insurance to protect against the risk of flood damage, and we buy life insurance to protect other family members against the financial risk of our premature death.

It is the risk of premature death that motivates most purchases of life insurance protection. Anyone who knew for certain that they would live to a very old age would be foolish to waste money on life insurance. If a long life was a certainty, and it would only be necessary to set aside a small sum for the eventual funeral.
However, none of us can be certain that we will live for a long time. There is always the possibility that a disease or accident will end our life. Any of us could become a victim of a natural disaster, an accident, or an act of violence. A long life cannot be guaranteed, even for those whose ancestors have a record of longevity and those who follow a healthy lifestyle.

The risk of an early death is evident to most of us, particularly when we have family obligations, dependent minor children to provide for, and unpaid debts.

The death benefit is the primary purpose for buying life insurance.

**Premature Death**

Premature death can be defined as the death of a working person with outstanding or unfulfilled financial obligations, such as family members to support, children to educate, and a mortgage to pay off. The costs of premature death include the loss of income to the family, additional family expenses, possible decline in the family's standard of living, and noneconomic costs, such as grief and the loss of a role model for the children.

The ownership of life insurance is economically justified on a family member who earns an income that others are dependent on for part or all of their financial support. The financial impact of premature death is not uniform for all families and varies depending on the family structure.

If a single person with no dependents dies or a spouse in a two-income family with no children dies, that death is not likely to cause a serious financial problem for others. In contrast, premature death can cause great financial insecurity in a single-parent family, in a family with children in which both spouses work, and in a traditional, blended, or sandwiched family. The needs can be used to estimate the amount of life insurance these families need.

When premature death occurs, the family's share of the deceased person's future earnings is lost forever. If replacement income from other sources is insufficient to meet the family's needs, or if present savings and financial assets are limited, the surviving family members might experience considerable financial hardship.

**Financial Consequences of Dying**

The expenses and loss of income associated with premature death are the main reason for buying life insurance as well as the major factors in determining the overall need for life insurance.

The needs that may arise due to premature death depend upon the prospective insured's individual situation, such as family structure, marital status, and financial obligations. These needs may include one-time expenses (such as funeral costs), as well as a variety of continuing expenses and income needs. Some needs may be immediate and some may are in the future.

In order to help applicants plan for all possible contingencies, agents should be familiar with the wide range of costs and financial needs that may arise. Consumers may overlook some contingencies, and do not always realize that multiple contingencies could occur. They may not be aware of the large amounts that these needs represent. Potential costs and needs create opportunities during sales presentations for agents to stimulate thought, and to expand the applicants understanding of the need for life insurance.

The most important family needs include the following:

**Final expenses** - Expenses before death, including health care and funeral expenses

- Doctor and hospital bills from a final illness
- Funeral expenses
- Probate and estate settlement costs
- Estate taxes
- Federal and state taxes for large estates
- Mortgage
- Loans, credit cards, and other debts
- Bequests to individuals or charitable organizations

**Readjustment income** - An amount provided to survivors to allow a transition from the current income level to a reduced income level

- Cash for emergencies
- Preventing a reduction in the family's standard of living, due to insufficient income.
- Child-care expenses for young dependent children

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Dependency income needs - Income required while children are dependent

- Continuing family income
- Funding children's education
- Retirement income for a spouse

Pure Protection

All life insurance contracts include the pure protection against the risk of a premature death. It is the loss of life that triggers payment of the benefit.

Life insurance may be used to fulfill a number of personal and family needs. With life insurance, the death of the insured creates an immediate estate for the benefit of the insured's family.

Non-insurance Elements

Many life insurance policies include non-insurance elements. Perhaps the most common of these is cash value. It may be closely associated with the concept of life insurance in consumers' minds, but it is not insurance at all - it is simply a low-yielding savings account. Periodic contributions are made, and the funds earn a fixed rate of interest. Cash value accumulation has nothing to do with mortality or the general insurance concepts of risk of loss and the pooling of large numbers.

A variation of the cash value element is the investment account or the variable account in policies that make use of variable returns or equity investments instead of fixed-return cash values. This is a separate savings or investment element that has nothing to do with the insurance element in the contract. This could also be accomplished through other investments such as mutual funds.

Some policies, known as participating policies, pay periodic dividends which may be taken in cash or used to accumulate additional amounts of death benefit and/or cash value. Dividends are not insurance. Premiums for participating policies are generally higher than for non-participating policies, and dividends are considered to be a return of the excess premium charge. But dividends have often been used as a successful sales tool, because some people like the idea of getting something extra back, even though they pay more initially.

Tax-advantaged growth makes permanent life insurance an attractive wealth accumulation vehicle as well as sources of financial protection. Conventional life insurance is appropriate when the need is primarily or exclusively for the financial protection element. The assurances offered through the contracts' guarantees are of paramount importance.

If wealth accumulation is part of the product's intended purpose, variable contracts offer advantages over their traditional counterparts. Potential for above-average returns make variable contracts suitable for investors with long-term investment horizons.

LIFE INSURANCE IS NOT JUST LIFE INSURANCE

The need to cover expenses and replace lost family income due to early death is the main reason that people purchase life insurance protection, but it is not the only reason to purchase life insurance products. Originally, life insurance contracts only provided death benefits. That has changed. Today, many forms of life insurance include other types of benefits. Most people also buy life insurance to protect against the risk of living for a long time, or outliving their financial resources. Life insurance is usually associated with death; however life insurance may be used to treat two exposures: dying too soon and living too long.

Some policies have cash value or other savings or investment features. Life insurance products may also be used to protect against some of the risks of not dying at an early age. This could also be accomplished through other investment vehicles, such as stocks, bonds, and mutual funds.

Each insured faces one of two possibilities: dying too soon or living too long. Unfortunately, most people save and invest too little.

FINANCIAL CONSEQUENCES OF LIVING

The risk of living to a ripe old age creates additional needs and must also be considered in the planning process. People set financial goals in life, but without a plan to reach those goals, they may never be achieved. Life insurance products and investments such as stocks, bonds, and mutual funds often play a role in helping people reach the
goals associated with living. Some of the possible financial needs that may arise as a consequence of living include:

- Funding children's education
- Providing retirement income for an insured
- Providing retirement income for an insured's spouse
- Providing a contingency fund for emergencies
- Building an estate value

Some of the financial needs associated with living overlap with those associated with dying, such as the need to fund education for children. If a parent dies prematurely, a life insurance death benefit can cover this need, and if the parent lives, the cash value in the policy will provide funds for this purpose.

Providing retirement income for a spouse is another area where the needs associated with living or dying overlap. The need to provide the insured's own retirement income arises only out of the risk of living, but it is one of the major reasons why people buy cash value life insurance.

Although many people think that the greatest threat to family security would be dying too soon, particularly if death occurs while there are young children involved and before the mortgage is paid, however living too long can create particular financial problems. Inflation may erode financial resources if retirement income benefits fail to keep up with increases in the cost of living. If a person requires medical care or assistance with daily chores and these expenses are not covered by some form of insurance, assets that were accumulated over a lifetime may have to be used to pay the bills. Life insurance can build a contingency fund for emergencies in addition to a fund to provide retirement income.

**LIFE INSURANCE AS A PROPERTY**

Few people consider life insurance as property. Is it possible for a premium payment of $100.00 to create an immediate estate or property valued at $250,000.00? That is possible with life insurance. Here are some advantages of life insurance as property:

- As an asset it is very secure.
- There is no managerial care.
- It can be purchased in any desired amount.
- It provides a reasonable rate of return.
- Proceeds are payable immediately.
- Policy owner chooses the method of payment for premiums.
PERSONAL USES OF LIFE INSURANCE

Life insurance can solve a wide range of financial protection and wealth accumulation needs. Here we look at the additional advantages gained through the use of life insurance.

People need to pay the high cost of dying, if they are not to leave their families with this expense. Families need to be able to pay off the mortgage or provide rent and children’s education must be provided for. The family must have income, whether or not the breadwinner lives to provide it.

Of course, not everyone has the same needs, but as the lives most of people and their needs are similar. Life insurance has features which enable it to meet the needs of widely varying life styles.

During a lifetime, individuals find themselves in various economic circumstances that directly affect their need for financial products. These changing financial situations, along with the uncertainty about how long an individual will live, form the basis of life insurance planning.

THE HUMAN LIFE CYCLE

The human life cycle can be described in terms of three economic phases. Most people are "consumers" from birth to age twenty-two, during the growth and education phases of their lives. The work, or "savings" phase runs from the end of the education phase until retirement. (If a couple has children, then the "savings" phase continues until the children finish their "education" phase.) At retirement, people become "consumers" again. If they wish to have an adequate amount to "consume" during retirement, people need to build surplus during the working phase. They must consume less than they earn. Some people also want to build large enough estates to pass on assets to their heirs, or to a charity. Others only want to build an estate big enough to live on until they die.

Singles

The number of single people in the United States has increased over time. Many younger people are delaying marriage, many adults are single because of divorce, and others because of the death of their spouse.

If a single person dies leaving no dependents or outstanding financial obligations, that death is not likely to create a financial problem for others. Such a person needs only a modest amount of life insurance to cover funeral expenses and uninsured medical bills. However, single persons should realize that their insurance needs could change in the future, and they might be wise to purchase life insurance early in life. Premiums will be lower and insurance might be more easily available than later in life when the need might be greater.

For single adults a life policy will enable them to provide:

1. An immediate estate to pay their last expenses and any debts, including particularly for young adults; the cost of repaying college loans.
2. Guaranteed future insurability. While the single adult may not be able to keep healthy, he or she can remain insurable once covered.
3. Tax-deferred growth of cash values that may be used during retirement.

Single-Parent Families

The number of single-parent families with children under age eighteen has increased substantially in recent years. This increase is primarily due to the large numbers of children born outside of marriage, widespread divorce and separation, and the incarceration or death of a parent. In most cases, single-parent families are headed by women.

Premature death of an income earner in a single-parent family can result in financial devastation for the surviving dependent children despite the possibility of receiving Social Security survivor benefits. Thus, the need for life insurance is great. Since death means no one remains to raise the children, single parents need to provide money for someone else to raise the children in their place. And they need to provide money to pay off debts and last expenses. Unfortunately, many single-parent families have low incomes, and their ability to purchase large amounts of life insurance is limited.
Two-Income Families

In many families today, both spouses work. The proportion of women in the labor force has increased dramatically over time, especially married women with children.

Households in which both husband and wife work outside the home are the fastest growing segment of the population. The reasons for two-income families range from the desire for a career, or the wish to sustain a higher standard of living, or perhaps a major purchase such as a home. In the case of married couples with children, the extra cost of raising a family, including the cost of education, is reason enough for two incomes.

In two-income families with children, premature death of either spouse can cause financial insecurity for the surviving family members because both incomes are usually needed to maintain the family’s customary standard of living. The need for life insurance on both spouses is great to replace the lost earnings, so the family can maintain its previous standard of living.

In the case of a married working couple without children, premature death of one spouse might not create severe financial problems for the surviving spouse. The surviving spouse is already in the labor force, childcare costs, and the cost of a college education for children is not a factor. However, other concerns, such as indebtedness and current or future financial support of parents or other relatives, might prompt the need for life insurance.

Traditional Families

"Traditional families" are those in which only one parent (traditionally the father) is in the labor force, and the other parent (traditionally the mother) stays at home and takes care of the dependent children, and possibly dependent elders as well. Traditional families have declined in relative number over the last few decades. Premature death of the parent in the labor force can cause great financial loss for a traditional family. The need for life insurance for breadwinners is well established. Although the surviving family members might be eligible for Social Security survivor benefits, the benefits will probably be inadequate to meet the family's needs. If the amount of life insurance on the deceased parent is insufficient, the family's standard of living is likely to decline.

Blended Families

A "blended family" is one in which a divorced person with children marries someone who also has children. Premature death of a working spouse in a blended family can cause great financial difficulty for the surviving family members, and the need for life insurance is great. Both spouses might be in the labor force, and two incomes are needed to support the blended family. The premature death of one spouse may result in a reduction in the family's standard of living. In addition to children present from the previous marriages, additional children may be born in the new marriage. As a result, child-care costs may be incurred over a longer period, and funds for the parents’ retirement and children’s college education may have to compete for limited funds. Financial planning regarding estate distribution may also be especially important for these families.

Sandwiched Families

The increase in life expectancy over the last few decades has proportionately increased the number of older people in the total population. Often, an aged parent receives financial assistance or other assistance from a son or daughter. A “sandwiched family” is one in which a son or daughter with children provides financial support or other types of assistance, such as physical care, to one or both parents, leaving them "sandwiched" between the older and younger generations. Premature death of an income earner in a sandwiched family can cause enormous financial hardship to the surviving family members. Death of a caregiver can also be devastating and result in the need for thousands of dollars per year to pay for substitute care.

Juveniles

An obvious advantage of a juvenile policy is coverage to pay the child's last expenses in the event of premature death. For many parents, this is what most people don’t realize it that the need for life insurance on the spouse staying at home can be equally important. The death of this spouse can result in significant expenses, such as child-care and housekeeping. Although the life insurance amounts needed might not be as high as those for the working spouse, the lack of insurance can have a negative effect on the surviving family's standard of living.
a hard sell since the death of a child is not something they wish to contemplate.

However, a life insurance policy on the life of a child can also protect insurability, and also offers a unique opportunity for cash value accumulation. Since the cost of insurance is lower in a child's early years, most of the premiums paid go into cash value which grows with interest. When a child reaches college age this accumulated cash value may be used to pay the cost of education. And eventually the cash value may be used to purchase a home or start a business. Parents may be more receptive to insuring children when these reasons are discussed.

COLLEGE PLANNING

Life insurance purchased on a parent's life for the purpose of funding a child's college education offers several advantages over other forms of saving. Only life insurance can guarantee to complete a college saving plan in the event of the family breadwinner's death. Fortunately, it is more likely that parents will live to see their children attend college than die prematurely, in which case the policy's cash value can be borrowed or withdrawn to help cover college expenses. Tax-advantaged borrowing makes permanent life insurance a popular source of college funding. If the policy was purchased on the child's life, ownership can be assigned to the child as a gift upon graduation.

RETIREMENT PLANNING

The possibility of insufficient income during retirement is another important loss exposure. Most workers retire voluntarily by age sixty-five. The major financial problem for retired workers is insufficient income. When workers retire, they lose their regular earnings. If replacement income from Social Security, private retirement plans, and personal savings is inadequate, the retired worker's previous standard of living may be reduced. The problem of insufficient income is aggravated if the retired worker lives unusually long, incurs catastrophic medical expenses or needs long-term care in a nursing facility.

Saving for retirement has assumed greater prominence in recent years, fueled largely by the realization by the immense baby boomer generation of the need to save for what was once a remote concern.

Life insurance plays a well-established role in many people's retirement plans. Life insurance will complete a survivor's retirement plan in the event of the insured's premature death, while insureds who live to retirement find life insurance cash values to be an important source of retirement income.

ESTATE PLANNING

Estate planning usually has two primary goals: (1) to reduce the size a one's taxable estate and (2) to pass on as much of the deceased's estate as possible to heirs. These goals can be accomplished through property transfers and use of the unlimited marital deduction. If a family's estate is sufficiently large, however, estate taxes become unavoidable. Since the unlimited marital deduction can put off the tax liability until the death of a surviving spouse, "second-to-die" life insurance is a popular estate planning tool.
BUSINESS USES OF LIFE INSURANCE

Various types of life insurance policies may be used for business purposes. Many businesses buy Key Person life insurance covering the lives of owners, executives or managers. Employers frequently include Group Term life insurance in their employee benefit packages. Businesses often plan for continuation of the business following the death of an owner, partner or stockholder, by executing buy-sell agreements which are funded by life insurance.

Life insurance may also be used to fill a variety of special business needs. Businesses need to protect against premature death of principals, and other key employees, and need cash to dispose of business interests upon their death.

The three most common types of business with which you will be concerned are the:

- Sole Proprietorship
- Partnership
- Close Corporation

A sole proprietorship is an unincorporated form of business owned and managed by an individual. The sole proprietor has unlimited liability with regard to the business operation. Creditors can claim both the sole proprietor's business assets and personal assets. When the sole proprietor dies, the business becomes part of the deceased's estate and is commingled with other personal assets subject to taxation, the payment of debts and claims of creditors. Life insurance can be used to fund a business continuation agreement by providing necessary cash with which to keep the business doors open until the business can be sold at its fair market value for the benefit of the family, or the business can be continued by a family member.

A partnership is a legal, non-incorporated business relationship involving two or more individuals who each contribute their unique skills, talents and capital for the purpose of owning and operating a business enterprise. When a partner dies, the surviving partner(s) usually becomes a liquidating trustee, dissolving the business in order to settle the deceased's estate. Life insurance may be used to fund a buy-sell agreement or a cross purchase plan so that surviving partners purchase the deceased partner's interest.

Regardless of the type of business organization, there are three risks which must be faced by the owner of a business interest. He or she will either:

- Die, or
- Become disabled, or
- Retire

When any of these three eventualities occurs, one of three things must happen to the business. It will either be:

- Sold
- Continued, kept in operation by the family or former employees
- Liquidated, or sold

Various agreements backed by life insurance may be used to provide for temporary continuation and eventual sale of a business upon the death of a sole proprietor, purchase of a business by surviving partners, or the purchase of stock in a corporation when a major stockholder dies.

LIQUIDATION

In the case of a sole proprietor, death of the owner could result in an abrupt end of income for family members and the forced liquidation of business assets at a fraction of their value. Life insurance proceeds may be used to pay a competent employee or manager to keep the business running until it can be sold at its fair market value.

Many proprietors have very specific ideas of what they would like to see done with his or her business at death. Sometimes the business is the sole means of livelihood of a number of partners or stockholders. In these cases, the liquidation alternative is not acceptable if it can be avoided. But sometimes liquidation, even at a loss of as much as 50% of the business value, is the only practical alternative, since a substantial amount of cash is needed at the owner's death. A life insurance policy on the owner can often prevent liquidation and preserve the value of the business to be sold or passed on to heirs or dependents.
RETENTION

If the family wishes to continue the sole proprietorship after the death of the owner, life insurance on the life of the sole proprietor may be purchased in an amount sufficient to meet estate settlement costs and to provide a financial "cushion" during the often difficult transition from the founder of the business to his or her successor.

Reorganization of a partnership is greatly facilitated if all the partners execute a buy-sell agreement and fund it with life insurance. In this manner, at the death of any partner, life insurance will furnish the surviving partners the cash needed to purchase the deceased partner's interest from his or her estate. The surviving partners may then proceed with reorganization according to their own wishes.

The family interest in a close corporation may be retained through a partial stock redemption. Section 303 of the Internal Revenue Code allows a corporation itself to redeem (or purchase) enough of its stock from the owner’s estate to pay death taxes, funeral costs, and administration expenses. Since this is only a partial redemption, the family retains ownership in the business.

Typically, Section 303 redemption, integrated into an overall estate plan, operates like this: The close corporation purchases and retains all ownership rights to a life insurance policy on the life of the owner of the stock in the close corporation. The close corporation pays all premiums to keep the policy in force.

When the insured dies, the life insurance company pays the proceeds of the policy to the close corporation. The corporation then uses this money to redeem (purchase) shares of the corporate stock from the insured’s estate. Only enough shares are purchased to pay death taxes, funeral costs and estate administration expenses, while the remainder of the shares (the remaining interest in the business) passes via the insured’s will to his son or daughter or other family member. The term "partial redemption" comes from the fact that only part of the shares are redeemed to pay expenses.

The end result of a Section 303 redemption is that the family now owns the business outright and can carry on just as they wish.

BUY-SELL AGREEMENTS

Life insurance may also be used to fund various types of buy-sell agreements which enable businesses to continue after the death of an owner.

Selling a business interest involves a substantial amount of planning. Such planning includes finding a willing buyer, preferably among surviving partners or stockholders, or perhaps employees of the business. In any type of arrangement, an important ingredient is an agreement by the buyer and the seller that, in the event of death, the deceased's business interest will be sold at a predetermined price. Such an agreement is called a buy-sell agreement. An essential provision in such an agreement is the funding provision, since without funds to buy, even the most carefully prepared buy-sell agreement isn't worth the paper it's typed on.

Funding is where life insurance plays a vital part. The needed funds are available at exactly the time needed: at the death of the owner of the business interest. Insurance on the life of the owner of a business interest, payable to the beneficiary who is the buyer of the business interest, can fund the buy-sell agreement with precisely the amount needed, at precisely the right time.

There are two general types of buy-sell agreements:

1. The entity-purchase buy-sell, and
2. The cross-purchase buy-sell.

The major difference between the two is the identity of the buyer (and beneficiary) of the insurance to fund the agreement. In an entity-purchase buy-sell plan, the business entity, usually a partnership or corporation buys the insurance on the life of each principal that will provide the cash the business entity will need to purchase the deceased principal's interest in the business.

In a cross-purchase buy-sell plan, the principals in the business, the partners or stockholders, each buy insurance on each other to provide the cash each will need to purchase a share of the deceased's interest in the business. Under a cross-
purchase plan, in a partnership having six equal partners, 30 policies must be issued if each of the six partners buys life insurance on the other five partners.

Regardless of the type of buy-sell plan, any buy-sell agreement should provide:

1. That the business interest will be sold at a predetermined price, and
2. That the business interest will be purchased at a predetermined price, and
3. A funding mechanism for the agreement.

Some buy-sell agreements provide for a fixed-value agreement which arranges for periodic fixed increases as the value of the business increases. Other types of buy-sell agreements provide for evaluation of the business by applying an appraisal formula. In either situation, the amount of coverage kept current to match the current business valuation, however established. The plan must be re-evaluated from time to time.

In the case of a partnership, the business must be dissolved upon the death of any partner. Partners may plan for reorganization and continuation of the business by executing a buy-sell agreement in advance, under which each surviving partner would purchase a share of any deceased partner's interest. Each partner may take out life insurance on the life of every other partner, or policies covering each partner may be payable to the partnership, to provide the funds for the purchase.

Buy-sell agreements in the form of stock purchase plans or stock redemption plans backed by life insurance are also used by corporations which have a few stockholders, or a few major stockholders, when ownership and control of the business is an important issue. The surviving spouse of a deceased major stockholder may not have the knowledge and experience to make sound business decisions, and remaining stockholders may not want an inexperienced stockholder voting on major policy issues. To avoid this problem, major shareholders may execute a stock purchase plan in advance, under which each agrees to purchase a proportionate share of any deceased shareholder's stock. To fund the purchase, each shareholder would become the beneficiary under life insurance contracts on the lives of the other major shareholders.

Life insurance is widely recognized as a logical means of funding partnership buy-sell agreements and corporate stock redemption plans. The death benefit amount is of critical importance, since it is usually targeted to the agreement's funding requirement. But, whether the policy is owned by an individual (in a cross-purchase arrangement) or by the corporation itself (in an entity-purchase arrangement), the policy's cash value is still a valuable asset.

**KEY PERSON INDEMNIFICATION**

Many corporations recognize that certain employees play an exceptionally important role in the company's success. The company is often dependent on their vision, creativity, or skill. The death of a key person may have serious consequences for a business, ranging from a loss of customers and income to the expense of finding and hiring a replacement. Many companies protect their financial interest in these key employees with life insurance called Key-Person life insurance. Coverage is frequently in the form of annual renewable term, or perhaps 5-year or 10-year level renewable term, and the proceeds are payable to the business. If it's permanent life insurance, the cash value represents an asset of the company. The key employee is the insured party, but the company is the policyowner and beneficiary.

Life insurance enjoys the same tax-favored treatment when used in meeting a key person need as it does when used with any personal need. Because the company owns the policy, it may use the cash values to meet any financial need encountered.

**DEFERRED COMPENSATION AND EXECUTIVE BonUSES**

Some companies set up benefit plans for executives which allow highly-paid officers to defer current income or bonuses and to receive the funds at a later date (such as after retirement) when they might be in a lower tax bracket.

Life insurance is often used to informally fund a nonqualified deferred compensation plan. As an asset of the corporation, it enables the company to promise a preretirement death benefit in addition to retirement benefits. At retirement, the corporation is obligated to pay the employee the deferred
compensation, which is usually equal to the policy's cash value.

**SPLIT DOLLAR PLANS**

These plans allow employees and employers to share premium payments and benefits. This arrangement often allows a key employee to have additional life insurance at a reasonable cost, and the employer to eventually recapture its investment in premiums.
DETERMINING THE AMOUNT OF LIFE INSURANCE TO OWN

In most cases, an agent must first determine how much coverage is needed before even considering the types of insurance to recommend. Making that determination requires a detailed analysis of the level of security the prospect needs and wants.

Introduction to Human Life Value & Needs Analysis

- Assisting individuals in determining appropriate life insurance coverage is a key aspect of the life insurance agent’s job.
- The human life value approach was an early attempt to approximate an insured’s life insurance requirements.
- The human life value approach relies upon two factors to determine suitable life insurance coverage: earning capacity and dependency.
- The human life value approach to determining life insurance coverage amounts has serious flaws, the most significant flaw being its lack of relationship to actual needs.
- Insurance needs analysis provides the life insurance agent and insured with a realistic and meaningful assessment of an individual’s life insurance requirements.

The limit of liability is the maximum amount the insurer will pay for a specified insured contingency. Life insurance policies usually use the term face amount to refer to the maximum liability of a death claim. Most American families are underinsured. The average amount of life insurance in force per household in the United States is only $150,100.

Conducting a needs analysis is not an exact science. Each prospect has different needs, priorities and resources. Many variables need to be considered and no set formula can produce the “correct” answer for all prospects. This is why it is important for an agent to be familiar with the concept of analyzing needs. Even if tables or computers are used to manipulate the numbers and generate proposals, an agent still needs to rely on personal judgment when gathering data. The agent also needs to understand that the process is very interactive and that close attention must be given to the needs being expressed by a prospect when answering questions.

Tools for Analysis

It is generally recognized that a more, formal approach to needs analysis is desirable. Many companies provide their agents with formulas, checklists and charts to help in estimating amounts of insurance to recommend. Some of these tools may be used to project the time value of money, and to convert monthly income needs for a specified, period into an aggregate amount of coverage. Checklist items help to identify specific needs which might otherwise be overlooked. Computer software programs may be available to analyze overall needs once all the key questions about desired income and benefit levels have been answered.

Insurance Amount: Gross Estimate

Usually, each of the separate needs is considered and an amount of insurance is then established for each. However, the amount of insurance needed is not always clear cut. Judgment often enters the picture. In some areas it may be necessary to estimate a sum that might be appropriate.

The items identified during a needs analysis are used to develop an estimate for an overall amount of insurance needed. Think of this as a gross estimate, because other sources of funds and benefits must be taken into consideration before an actual recommendation can be made.

The appropriate amount of insurance for certain needs will be easier to establish than for others. The current unpaid balance of a mortgage and any other loans might be appropriate to cover with decreasing term insurance.

In some areas, particularly when it comes to continuing income needs for survivors or retirees, there are many variables to consider. Interaction with the prospect is a vital part of this process. As part of the information gathering process, an agent should raise some very relevant questions regarding the prospect’s wishes. What is the particular lifestyle and level of income that the insured wants to preserve? Is the spouse also working, or would the spouse plan to go to work if the insured dies?
Time factors need to be considered. The number of years this income will be needed. Until the children grow up? Until retirement income for the spouse begins?

If funds for children's education are an identified need, the agent needs to determine how many children there are, how old they are now, when the funds will be needed, and what average college costs might be at that time.

Inflation should be considered if particular needs lie far in the future. Otherwise, the fund being accumulated may be inadequate. The goal of the plan should be to provide a fund large enough to produce the desired income for the required number of years.

In cases where lifetime incomes are being contemplated, insurance company benefit schedules may be helpful to determine appropriate amounts. Each company provides settlement option tables that show the dollar amount of monthly benefit payable per $1,000 of insurance proceeds. These figures indicate how much cash value would be needed to provide a lifetime income for a recipient of a particular age.

**Other Sources of Funds**

Once gross estimates are made for the various life insurance needs, other sources of funds that may reduce or eliminate those needs should be considered. An overall gross estimate may be considerable (hundreds of thousands of dollars or, perhaps, over a million), but other sources of funds and benefits may reduce it significantly.

Regardless of the approach taken when determining insurance needs, other sources of funds should be considered when calculating the need for additional life insurance, such as:

- Other insurance
  - Existing medical insurance (may cover cost of last illness)
  - Existing life insurance (individual and group)
  - Credit insurance (may cover debts and mortgages)
- Social Security (may provide survivor's benefits and/or retirement income)
- Medicare
- Medicaid
- Vested pension benefits (death benefits, retirement income)
  - Group retirement plans
- Personal savings, assets and investments (IRAS, etc.)
  - Savings
  - Investments
  - Other income (rental property income, etc.)
  - Annuities

These other assets will help in determining the amount and kind of insurance necessary to meet the applicant's current and future needs. When estimating the potential contribution of Social Security benefits to survivors' income, agents should be aware of something known as the blackout period. This is the period of time after the youngest child is 16 years old and before the surviving spouse becomes eligible for retirement benefits. During this period, no benefits will be paid by Social Security to a surviving spouse.

Offsetting benefits may reduce or even eliminate some of the items in the needs list. If existing medical insurance has a large lifetime benefit, any uninsured exposure related to a last illness may be limited to the deductibles and coinsurance, if any. Existing life insurance may substantially reduce a number of needs. Group life insurance will not provide a retirement income, but it will reduce the need for insurance by a working parent working with minor children in the family. An unpaid mortgage may already be fully insured by a credit life policy. Social Security and other available benefits might cut the remaining need for retirement income considerably.

**Insurance Amount: Net Estimate**

By considering all offsetting resources and benefits, the aggregate need for insurance can be trimmed to the unmet need for insurance - the gap to be filled in order to satisfy the established goals. This net estimate may be used as the basis for a specific sales proposal. The nature of the unmet needs might also suggest the amounts and combination of types of insurance to recommend, such as a specified amount of whole life or other form of level coverage and a specified amount of decreasing term coverage.

There are two basic methods for measuring life insurance needs: the human life value approach and the needs approach. Each approach is a tool to help determine the amount of life insurance needed by an individual or family.
The Human Life Value approach uses mathematical computation to determine how much life insurance is needed by valuing a human life. The Human Life Value approach considers the human being to be an "income-producing machine." It is a device that mathematically converts the output of the prospect into an amount of cash; the client's expected income until retirement. The human life value approach determines the value today of cash that is flowing from the prospect in the future.

This method focuses on an individual's future stream of income. It considers such things as annual salary and expenses, years remaining until retirement, and the future value of current dollars, and translates this into an amount of insurance needed to replace the income stream in the event of premature death.

In the human life value approach, the first step is to find the amount of annual income that is surplus to the individual. The surplus is the amount above what the insured would consume himself; which provides the overall standard of living for the individual and the family. The surplus includes amounts spent on education for children, automobiles, vacations, clothing, and food for everyone in the family except him. The items to include in costs of self-maintenance are any money spent on his portion of housing, his clothing, food, the portion of his salary that goes for FICA, federal, state, and local taxes, and all other expenses to maintain the insured as a productive asset.

The next part of the human life value approach involves plugging the given information into the mathematical model and calculating the answer. To determine the surplus, subtract the self-maintenance expenses from the average income.

The amount of any current life insurance is deducted along with the Social Security benefits, any savings accounts and investments, together with the present value of income that would continue if he dies (such as trust funds, or rental income). Subtracting these amounts from the human life value reveals the amount of life insurance needed.

When using this approach, the producer should keep in mind the importance of involving the client in the process, as well as the importance of the assumptions on which the calculation is based, and the potential for change.

Like any tool, its effectiveness depends on how it is used and the validity of the information used, such as:

- Average expected income during the working period
- The time horizon, or expected working life
- Costs of "self maintenance"
- An interest rate that could be earned, on average, over a long period of time

Importance of Client Involvement

In determining a prospect's life insurance needs, the producer should involve the prospect in constructing the plan as much as possible. This way, the client feels more like the plan is his or her own. As a result, the client is more likely to accept the amount of insurance that is finally determined. If the producer fails to involve the prospect, the plan is easier for the client to reject.

Gathering Client Information for Needs Analysis

- Understanding the individual's life insurance needs using the insurance needs analysis method requires that the agent know the individual.
- The data-gathering interview is considered by many agents to be the most important client meeting in the sales process.
- The five principal areas in which data-gathering must be accomplished are income, assets, liabilities, goals and risk tolerance.
- Obtaining the needed information from prospects requires that the agent build rapport and create trust.
- The most effective information gathering involves the agent's understanding of both the facts and their emotional content.

Importance of Assumptions

Mistakes or changes in assumptions can significantly change the results of the human life value calculations. If the estimate of the interest rate is incorrect, the figures change substantially. The
projected retirement age also affects the human life value calculation.

Because each of the underlying assumptions used in this technique is variable over time, the human life value approach requires regular review and updates. "Financial checkups" are a valuable service producers can provide to clients. Financial plans must be flexible since the client's needs and circumstances often change greatly over a period of time.

**Best Prospects for the Human Life Value Approach**

The human life value approach appeals to prospects who are mathematically oriented. Agents should use the human life value approach with prospects most likely to acknowledge its validity: engineers, accountants, architects, and others familiar with, and comfortable with, mathematical models.

**THE NEEDS APPROACH**

The needs approach is a method used to determine an adequate amount of life insurance based on the survivors' needs and the amount of existing life insurance, financial assets, and expected Social Security benefits.

This technique focuses on the needs of survivors, instead of the value of the insured's earnings that will be lost. It considers such things as funeral expenses, possible last illness, continuing family income needs, children's education, and spousal retirement income, and translates these into an amount of insurance to provide for the survivors.

The purpose of a needs analysis is to determine the overall need for insurance, contributing sources of benefits, the net amount of additional insurance needed, and the most appropriate types of insurance to meet the prospect's goals.

The needs approach is widely used to determine the amount of life insurance to purchase. Under the needs approach, a family's financial needs are estimated after taking into account any Social Security survivor benefits or other benefits that might be available. The amount of existing life insurance and financial assets is then subtracted from the family's financial needs to determine the additional amount of life insurance required, if any, to meet these needs.

A full needs analysis includes consideration of the possibility of living as well as that of dying. Although a big part of the reason for identifying needs is to help determine an amount of insurance, the nature of the needs revealed will also suggest the types of life insurance which may be appropriate for satisfying these needs. Term insurance can be used to cover the needs associated with premature death, but in order to accumulate funds for retirement income, education or emergencies, a person needs a policy which includes savings and investments.

Although the human life value approach and the needs approach generally give the same results for any given situation, the needs approach is less mathematically complicated and can help policy limits to be more accurately matched with a client's perceived needs. The needs approach is still based on accurate financial information and must be coordinated with all of the prospect's financial resources such as OASDHI and group insurance. It focuses on what the prospect would like to have happen to the family after his or her death and on the very real possibility that the prospect will live on into retirement. It is much easier for most people to understand than the human life value approach.

**Identifying and Calculating Lump-Sum Needs at Death**

- Lump-sum survivor needs often include the need for immediate cash to pay last expenses, liquidate consumer debt, provide a fund for emergencies, redeem a mortgage, provide dependent care and pay for education.
- Seventy percent of a prospect's lifetime medical expenses are often incurred in battling a final illness.
- A single month's survivor income should be provided as a cash need in order to meet expenses while ongoing income arrangements are being made.
- A general guideline for estimating immediate cash needs is 30 – 50 percent of the family's gross income.
- A family's debts don't die when the breadwinner dies. They are passed down to the survivors.
- Establishing an emergency fund for survivors helps provide some of the financial flexibility that is lost.
following the death of the breadwinner.

- A general guideline for estimating emergency fund needs is 6 months of current gross income.
- Providing a fund for mortgage redemption should not require that the mortgage be redeemed. Rather, it should give the survivors the option to redeem it.
- Dependents may include not only minor children but also aged parents and dependent siblings.
- When establishing an education fund, the education needs of the surviving spouse should be considered as well as the education needs of children.

### Need Categories

Many categories of needs should be considered:

- Needs created by final expenses
- Needs for readjustment income
- Needs for income during dependency
- Needs for capital
- Needs for income during retirement

The prospect gives the producer an estimate of the amount of money he or she will need to meet the expenses in each category. Those estimates are then matched with the prospect's resources. Any deficiency in existing resources can be made up with a life insurance product.

### Final Expense Needs

The first category in the needs approach is final expenses. The goal is to free the family of all short-term debts.

Cash would be needed immediately in an estate clearance fund for funeral expenses, uninsured medical bills, car loans and installment debts, and estate administration expenses.

Estimating the size of the final expense need is not easy. The cost of a funeral is probably the easiest to predict. A producer could contact a funeral director to determine current average costs of a funeral and how they might increase. The amount of money needed to pay off consumer debts may also be reasonably easy to estimate. Final illness expenses are the most difficult to estimate. The prospect cannot possibly know the length of the final illness. A prolonged illness would be more expensive than an accidental death or sudden death. In any event, it is probably a good idea to encourage the prospect to overestimate. Any money left over could be used as an emergency fund for unexpected expenses.

Federal and state inheritance or estate taxes are due in cash shortly after the time of death. The federal estate tax form must be filed within nine months of death. Although a credit shields estates under a certain amount from federal estate tax liability, the tax rate thereafter is sharply progressive. Marriage and charity deductions can reduce the impact of the taxes on the estate, but the wealthier the individual is, and the greater the amount of wealth tied up in illiquid assets, like real estate, the more important it is to have cash from life insurance to pay death taxes.

Life insurance is valuable as a source of cash even when the estate possesses assets that can be sold to raise the money to pay the death taxes. It is common for a forced sale of an asset to bring a low price. As a general rule, wealthy people who want to leave property to heirs face a growing and permanent need for substantial life insurance to make sure their goals can be achieved. This need falls into the final expense need category. The more successful the prospect, the more likely there will be a need for ready cash at the time of death to pay federal estate and state inheritance taxes.

### Readjustment Income Needs

Readjustment income is equal to the prospect's current take-home pay for a period of time sufficient for the family to adjust to the absence of the deceased's income. It is designed to allow a transition from the current income level to a reduced income level. This period of time typically runs from one to five years. The readjustment period should be long enough to allow as normal a home life as possible. An abrupt downward change in the family's lifestyle, on top of the death of a loved one, can be devastating, especially to children.

### Dependency Period

The dependency income needs include income required while children are dependent. More income is needed while the children are dependent than after they become self supporting. If the surviving spouse will not be going to work at all, the dependency period runs until when the insured would retire. If, however, the surviving spouse has a viable
career, the dependency period ends when the youngest child reaches age eighteen or twenty-two, when children usually either go to work, or until the youngest child graduates from college. The producer should inform the prospect of these various time periods so that he or she can more accurately estimate the needs in this category.

**Blackout Period**

The blackout period refers to the period during which Social Security survivor benefits to a surviving spouse are temporarily terminated. Under current law, Social Security survivor benefits will be paid to a surviving spouse with eligible children under age sixteen. The benefits paid to the surviving spouse terminate when the youngest child reaches age sixteen and do not resume again until the spouse reaches age sixty. The children's benefits, however, continue until the youngest child reaches age eighteen.

**Capital Needs**

Capital needs is a broad term encompassing many types of financial needs that must be met with cash. An emergency fund is one kind of capital need. It is cash that is available to pay for unexpected events. Mortgage payments are another kind of capital need. Here, the amount is known and can be planned for by setting aside a lump sum to pay the full amount of the mortgage, by investing a lump sum that can generate enough money to make monthly mortgage payments.

A capital needs fund can be used for any long-term financial obligation. The capital fund can provide for the payment of loans on a car, boat, or vacation home. Some people have even included in this fund $500 a year for twenty years for holiday and birthday gifts.

**Retirement Needs**

Retirement needs are financial needs that must be met after the prospect stops working. A retirement fund can be created by the cash values of a permanent life insurance policy. The retirement fund can be a lump sum of money to supplement retirement payments from OASDHI, private retirement plans, IRAs, and other savings. The key fact to present to the prospect is that the retirement fund should be enough to allow the prospect to enjoy retirement. Retirement income for a surviving spouse is another important need to consider.

To calculate retirement needs, anticipated savings, investments, and retirement income (private and/or retirement benefits of OASDHI) available at retirement are subtracted from the lump sum retirement need. The result represents the amount of cash values to be accumulated through permanent life insurance.

Retirement income should not be added to the other needs since retirement income will only be needed if the prospect lives on into retirement, whereas other needs are created only upon the death of the insured.

The prospect's involvement in the assumptions and calculations used in the sales process is crucial. Participation by the prospect makes him feel that he has built his own plan and has made his own financial decisions. This personal contribution and control makes it more likely that the prospect will be committed to his financial goals. It is very difficult for the prospect to reject an amount of insurance recommended. It also conveys to the prospect that the plan is personal and is the prospect's responsibility.

**Producer Use Of the Needs Approach**

The primary purpose of every life insurance policy is to provide funds upon the death of the insured. Also important is the accumulation of cash value that is available while the insured is alive. This cash value can be used to supplement the insured's other retirement funds if needed.

Life insurance should never be sold primarily as a retirement plan or an investment. Low cash values in the early years of the policy and the possibility of fluctuating interest rates can leave an insured with far less cash in the policy than expected at retirement. Those circumstances could also cause the premium to increase, and can even result in the policy lapsing due to insufficient premium and interest earnings.

When life insurance is sold to protect the insured's family or estate, it serves its primary purpose. The cash value aspect of permanent life serves a great need, but true retirement plans (IRAs, annuities, etc.) are the products designed primarily this purpose. Producers can avoid E&O claims by selling the proper product for the specific need.

After the needs analysis is complete, the agent should then make recommendations as to the amount and type of insurance needed by the individual.
TYPES OF LIFE INSURANCE POLICIES

Essentially there are only two basic types of life insurance policies: term and permanent. All life insurance is a variation or combination of these two basic types. To match a product to a need requires an understanding of the basic form, its strengths, and weaknesses.

- **Term life policies** cover a limited time period and are pure insurance plans. If death does not occur within the policy period, the policy does not pay.
- **Permanent policies** pay no matter when death occurs, by combining pure insurance with a financial plan. They act as insurance plans if the insured dies prior to completing a financial plan. However, the insured will accumulate savings if the insured does not die.

Life insurance policies fall into four basic categories:

- **Group** life insurance
- **Credit** life insurance
- **Industrial** or home service life insurance
- **Individual** or **ordinary** life insurance

**GROUP LIFE INSURANCE**

A specialized type of policy is group life insurance which covers the lives of employees or other group members. The group policy is issued to the employer, association, or labor union, and individual certificates of insurance are issued to each covered person. Benefits are payable to the insured person's designated beneficiary or estate. Group life insurance is usually issued in the form of annual renewable term coverage. Group term rates are based on the overall experience of the insured group and not on the ages or health of the individual group members.

**CREDIT LIFE INSURANCE**

Credit life insurance may be issued on an individual or group basis to cover the lives of debtors for the benefit of creditors. It is written specifically to protect the balance of an unpaid loan if the debtor should the prior to paying the indebtedness.

**INDUSTRIAL LIFE INSURANCE**

This form of life insurance is usually written for small amounts and is characterized by frequent premium payments (monthly or weekly) which are collected by the agent. Home service policies are a variation of this concept, which are sold on a debit payment plan, such as automatic bank drafts. The term industrial life insurance is considered interchangeable with debit or home service insurance.

**INDIVIDUAL OR ORDINARY LIFE INSURANCE**

Most often, agents will be recommending some form of ordinary, or individual, life insurance to prospects. The term "ordinary insurance" is sometimes used to describe individually-owned life insurance. Some ordinary life policies are issued on a participating basis, which means they pay dividends. Others are issued on a nonparticipating basis, and do not pay any policy dividends.

**TERM LIFE INSURANCE**

Term insurance, a form of temporary life insurance coverage, may be appropriate for many families that foresee decreasing insurance needs during their lifetimes.

Term life insurance policies provide pure protection. These contracts cover a person's mortality risk and pay a death benefit only if the insured dies during the specified term. The term may be specified as a period of time from the inception date (such as one year, five years, 10 years, 20 years, or 30 years), or as a period of time ending at a specific age (such as age 65). If the insured lives beyond the term period, the policy expires and no benefits are payable.

Term insurance has many practical applications for covering insurance needs and it may be combined with other elements of a person's overall financial plan.

Since term insurance is temporary life insurance, the use of term insurance should be related to
needs that are also temporary. The basic guideline is to cover temporary needs with term life insurance and permanent needs with permanent life insurance. If the prospect cannot afford sufficient permanent insurance, agents should temporarily cover the permanent need with term insurance rather than leave it unaddressed. The prospect may wish to convert the insurance to a permanent form when finances allow.

Term insurance has four basic characteristics:

- Term insurance provides temporary protection for a specified period, such as one, five, or ten years, or until the insured reaches a specified age, such as age sixty-five or seventy.
- Term insurance policies have no cash value or savings element. The insurance provides protection but no investment, and cash values do not accumulate.
- Most term insurance policies are renewable and convertible. Insurers typically do not allow renewal after a certain age, such as sixty-five, seventy, or seventy-five.
- Term insurance premiums increase with the insured's age and are based on mortality rates. Because mortality rates increase with age, term insurance premiums must also increase.

Mortality rates are the probabilities of death at specific ages. Life insurers have been able to predict mortality rates with a high degree of accuracy for large groups of people.

Term insurance policies may be characterized according to their renewability and convertibility provisions. Term insurance policies may be renewable, or convertible, or both, for a specified number of years without requiring evidence of insurability.

RENEWABLE TERM

Renewable means that a term insurance policy can be renewed for additional periods without evidence of insurability.

Evidence of insurability is a requirement by a life insurer that the insured demonstrate that he or she still meets the insurer's underwriting standards by submitting a medical questionnaire or having a physical examination.

Renewable term policies may be limited as to the number of renewals, or to a specified age beyond which renewals will not be available. When a term policy is renewed, the premium for the renewal policy will be based on the insured's age at the time of renewal.

A term policy is renewable only if the contract includes a renewal clause. When a policy does not include a clause specifically granting the right of renewal, it is a nonrenewable term policy.

A nonrenewable term policy is issued for a specified term and may not be renewed. An insured may always apply for a new policy at the end of the term, but there are no guarantees and the risk may be accepted or rejected based on current underwriting standards.

ANNUAL RENEWABLE TERM

Annual renewable term policies are term insurance contracts issued for one year at a time. In each year, the premium must cover the current mortality cost plus policy expenses. With this type of policy, the policyowner has the right to renew for successive one-year periods.

Each year the coverage is renewed, the premium for the same face amount increases because of the increase in the insured's age and probability of death.

Yearly renewable term insurance is the most common type of group life insurance used today. Large employee groups tend to be relatively stable, because each year some individuals retire or terminate for other reasons and younger individuals enter the group as new employees. If the overall mix remains similar, changes in group membership do not have much impact on premiums.

Annual renewable term insurance has limited applications for individual insureds, largely due to the fact that the premium rises rapidly at advanced ages. It is usually appropriate only when there is an immediate short-term need for insurance protection. For most individuals, longer term contracts are usually more practical.
CONVERTIBLE TERM

Term policies may also be convertible, which means the insured may convert to a permanent type of contract (such as whole life) without providing evidence of insurability. The right to convert may be limited to a number of years or to a specified age. Conversion is often exercised by someone who initially purchases term insurance to maximize protection at a minimal cost, and who later decides to change to a type of policy which the insured could not initially afford. The premium for any converted policy will be based on the insured's age at the time of conversion.

The conversion privilege is valuable. Conversion allows the insured to retain insurance coverage at higher permanent rates if they become uninsurable. However, once the right of renewal or conversion has expired, the insured is no longer protected against loss of insurability.

REENTRY TERM

A reentry term policy gives the insured the opportunity to provide evidence of insurability at the end of the term and qualify for reduced premium rates (lower than the guaranteed rate which is available for a renewable term policy). The premiums for this type of policy are substantially increased if the insured cannot provide satisfactory evidence of insurability.

TERM PREMIUM CONSIDERATIONS

LOWEST COST FOR PURE PROTECTION

Because term insurance provides pure protection only, it has the lowest premium cost per unit of protection. For any amount of insurance at a specified age, term insurance would have the lowest premium. For any amount of premium dollars at a specified age, term insurance would provide the greatest amount of coverage. Term insurance may be used to provide coverage when there is an immediate need for a large amount of protection, and a small income to pay the premium.

PREMIUM COMPONENTS

Term insurance premiums are based almost entirely on the mortality cost for the insurance.

TERM POLICY VARIATIONS

Term life insurance policies can be designed for almost any length of time. There are yearly term policies, five-year term policies, ten-year term policies, and twenty-year term policies. There are also term policies to age sixty-five.

The types of term insurance policies may be defined by the way the face amount of the policy changes, or doesn't change, throughout the term of the policy. The face amount of the policy is the amount of money payable as a death benefit. Generally, they fall into three categories:
LEVEL TERM

Level term insurance provides a level death benefit during the policy term, and is most appropriate where there is a known fixed obligation or contingency.

Level term policies may be used to provide a benefit of a specified size for final expenses, funeral costs, fixed obligations and a general transition period for survivors. Decreasing term policies are ideal for insuring a number of time sensitive obligations, such as paying off long-term debts and providing income for dependent children. Due to its lower cost, it might be preferred over whole life insurance when maximum protection is the current priority, especially when premium cost is an issue. In many cases, an individual’s insurance portfolio should consist of some level coverage and some decreasing coverage.

Frequently, level term policies are issued as five-year, 10-year or 20-year policies. In these cases, the annual mortality costs are balanced out and the annual premium, as well as the face amount, remains level for the entire policy term.

Level term policies are often issued as renewable and convertible policies. At expiration of a level term policy, all coverage ceases if it is not renewed. If it is renewed, a new term period would start and the premium would be based on the insured’s higher age at that time.

Term life insurance is often characterized as “pure” protection in that no benefits are payable at any time except upon the death of the insured during the policy term. It may be illustrated by the following diagram.

If the insured does not die during the term of the policy, the policy expires and no further obligation on the part of the insurer exists.

If the insured dies during the term of the policy, the beneficiary will receive the full amount of the policy, without regard to the particular year in which death occurs. With a basic term policy, the annual premium remains constant and is paid for the entire term of the policy and the level of protection remains constant.

DECREASING TERM

Decreasing term policies also provide temporary protection for a specified period of time, but the death benefit (face amount) decreases during the policy term until it reaches zero at expiration of the policy.

Many life insurance needs are time-sensitive - they decline as time passes. Decreasing term insurance is ideal for meeting many kinds of time-sensitive needs. One of the most common types of time sensitive needs is a long-term debt obligation, such as a mortgage, or other loan. Income needs may also be time-sensitive. This is particularly true in the case of providing for minor children who will not always be dependent upon the insured.

The need to provide income for a surviving spouse may also be time-sensitive to a degree. There is a time factor to consider between when death might occur and how long income may be needed. There may be a time factor between when supplemental income might be needed and when other future benefits may begin. However, supplemental income benefits may be needed for an indefinite period because other benefits may not exist or may be inadequate, and there is no way of knowing how long a surviving spouse will live.
The annual premiums for a decreasing term policy remain level throughout the policy term. Although the insured's mortality cost increases each year, the amount of coverage being provided is reduced, so the same premium dollars do not have to purchase as much coverage.

Although decreasing term policies are generally not renewable, they often permit the policyowner to convert the amount of remaining coverage into permanent insurance. The premium for the converted policy will be based on the insured's attained age at the time of conversion.

The longer one lives, the less need there is for life insurance to cover specific exposures related to debt obligations and temporary income for survivors. Additionally, as many people mature they accumulate assets - home equity, vested employee benefits, and personal savings and investments. Later in life there may be more assets available for family security, which reduces the gap that needs to be covered by life insurance.

While the principal behind each plan may be the same, there are variations in the rate of increase or decrease. Some plans change at a proportional step rate, others at varying curves as opposed to "straight line" with additional variations in frequency of change. Decreasing term life illustrations below show the differences.

**INCREASING TERM**

Another type of term insurance which is available is increasing term insurance. With this contract the premium remains level but the death benefit starts small and increases over the term of the policy. The structure of an increasing term policy is the opposite of decreasing term policy.

Increasing term insurance has fewer practical applications than other forms, and is used mostly as a sales tool to attach additional benefits to other types of policies.

There may also be some offsetting forces which can increase the need for insurance as a family ages. When a young couple has additional children, the need for protection may increase. As working people increase their income and accumulate assets, the standard of living rises and the perceived need for aggregate life insurance protection may grow. If an insured accumulates a large estate, the assets above exempt amounts are subject to estate taxes, which reach a maximum tax rate from 30% to 60% for very large estates.

Additional life insurance may be needed to protect the value of a large estate by providing funds for estate taxes. These are some of the reasons why an insured's changing insurance needs should be reviewed every few years by an agent.

Increasing term insurance is usually sold as a rider to other types of policies, usually whole life products. These riders are often called "return of premium riders" or "cost of living adjustment riders". In both cases increasing term insurance is used to purchase additional amounts of protection which would be paid as an additional death benefit.

**USES OF TERM INSURANCE**

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Term insurance has a variety of useful applications and is appropriate in three general situations:

- When income is limited and substantial amounts of life insurance are needed. Substantial amounts of term insurance can be purchased with relatively modest annual premiums. Since term insurance provides pure protection, it allows a person with a limited income to purchase more coverage than might otherwise be affordable.
- To meet a temporary need, such as the need for income during the readjustment, dependency, and blackout periods. Decreasing term can be used to pay off a mortgage or a loan if the insured should die while a balance remains.
- To protect insurability and provide a person with options for the future. The insured might wish to buy permanent insurance but might currently be unable to pay the higher premiums. He or she can purchase term insurance and convert it later into a permanent policy without evidence of insurability.

Adequate protection should be the first priority for most families. It might better serve the prospect's needs to sell the needed level of protection first, and then convert to permanent insurance or savings plans in the future.

Although term insurance can play a valuable role in an insurance program, two major limitations exist. First, term insurance premiums gradually increase with age and eventually reach prohibitive levels at older ages. Term insurance is not suitable for lifetime protection. Second, term insurance policies typically do not develop cash values. Term insurance cannot be used to save money, such as saving for retirement or accumulating a fund for the children's college education. Another savings program must be set up to provide these funds.

Once an agent has completed a needs analysis and determined an estimate, the unmet need for protection and/or savings, one or more proposals may be made using life insurance products to satisfy these needs. An agent will usually find that there are many opportunities to include term insurance products into a financial plan.

Individual financial planning almost always encompasses both insurance protection and savings or investment. Using term insurance in a financial plan allows an individual to separate these elements into two distinct parts of the plan. By treating them separately, some potential conflicts between the two goals can be eliminated and a better allocation of financial resources may be possible.

There are several advantages to using term insurance to deal with the need for insurance protection as a separate element in the financial plan. Doing so helps to clarify the amount of protection that is actually needed. It also helps to minimize the chance that excessive or inadequate amounts of the wrong type of coverage may be sold because of a preoccupation with cash value.

Because term insurance protection is available at the lowest cost, it will always leave more dollars for investment.

Eliminating possible overinsurance or underinsurance in the financial plan results in a better use of financial resources.

Fixed-return cash value policies provide a low return on savings and many alternative investments (such as stocks, bonds, and mutual funds) have performed better over long periods of time.

Many consumers are quite capable of managing the savings/investment side of their own financial plans. Using term insurance often makes it possible to maximize the dollars available for investment. While some consumers need to be “forced” to save at low fixed rates of return, knowing that more dollars are being made available for savings and that higher returns are possible may motivate many consumers to keep their savings and investment plan on track.

**TERM VS. WHOLE LIFE**

Whether term policies should be used in conjunction with or instead of permanent policies depends upon the situation. Some proponents of term insurance products argue that they should be used almost exclusively to satisfy insurance needs. Some proponents of whole life products insist that permanent insurance must be used as the foundation of every financial plan.
There is no reason why term coverage cannot be used as a valid alternative to whole life to satisfy many life insurance needs. What distinguishes whole life policies from term policies is that whole life products accumulate cash value. This is a savings account, and savings are important in anyone's long-range financial planning, but savings are not "insurance." Term policies may also be used in conjunction with savings or investments to accomplish similar or superior results.

**FORCED VS. VOLUNTARY SAVINGS**

Some agents argue that people need to buy whole life insurance because it forces them to save for retirement, and that otherwise many people simply would not save. Whole life policies represent a form of semi-compulsory savings. Since term coverage can be purchased at a lower premium cost, term insurance could, however, free up dollars which could be used for voluntary savings.

Some consumers need compulsory savings, and some don't -- it depends upon that person's propensity to save. One of the problems with buying term insurance instead of whole life and attempting to invest the difference, in the hope of a greater return, is that some people have difficulty saving. Some people are more committed to their financial goals than others. A person who understands the concepts of insurance and savings and who is committed to the separate goals, will succeed at buying term and investing the difference.

For many there may be a greater psychological commitment to making a whole life premium payment than to making a voluntary savings contribution or investment. People tend to pay their insurance premiums, but often delay or skip voluntary contributions to a separate savings plan. Proper guidance, such as the establishment of a systematic bank draft or payroll deduction for voluntary savings, may alleviate this problem.

**RATES OF RETURN AND RISKS**

The concept of buying term and investing the difference is viable and has merit. Clients buy term insurance rather than whole life, and save or invest the savings in premium in the hope for a better return.

Historically, the interest rates guaranteed by whole life policies have been low (3%-to-4%). These policies offer an extremely high level of safety for consumers, since the principal is fully protected and the interest rates and future cash values are guaranteed by the insurance company. This reflects a fundamental principal of risk and investment the lower the risk, the lower the return; the greater the potential return, the greater the risk.

Insurance companies can guarantee the rate of interest paid to policyholders because they expect to earn more on the use of the money. Cash holdings are invested and yield returns. Policyholders do not have to worry about safety, but they do not share in the investment gains either.

When life insurance is purchased as an investment, it is generally held for a long period of time (up to 30 or 40 years in many cases). Over a long-term, a few percentage points of difference in the return can make a great deal of difference in the principal.

<table>
<thead>
<tr>
<th>$2,000 Investment Over 30 Years at Various Interest Rates</th>
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<tr>
<td>$2,000 at 3% annually for 30 years</td>
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<td>$2,000 at 6% annually for 30 years</td>
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<tr>
<td>$2,000 at 9% annually for 30 years</td>
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<td>$2,000 at 12% annually for 30 years</td>
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In recent decades, we have seen rising and falling interest rates, rising and falling inflation, and rising and falling stock prices. Many mutual funds and common stocks have shown impressive long-term rates of return, but these are subject to wide fluctuations in value. While these investments may offer higher returns at times, they expose the investment to more risk.

What is best for any given policyowner depends upon the desired rates of return and the degree of risk the policyowner is willing to assume. In order to choose an approach, an individual would first have to make decisions about the degree of safety versus the degree of risk, preferences for fixed returns or variable returns, an understanding of how inflation impacts fixed returns, and whether or not the person would be comfortable managing long-term savings rather than having an insurance company do it.

During periods of inflation, and over long periods of time, equity-type investments have tended to keep pace with inflation and perform better than many fixed-return investments. Many people choose to combine both approaches by purchasing an amount...
of cash value insurance and then supplementing it with a larger amount of term coverage.

**ADVANTAGES OF TERM INSURANCE**

Proponents of term life insurance cite the following advantages:

- It provides the maximum amount of protection for the lowest premium cost
- It allows people with low incomes to purchase an adequate amount of immediate protection
- It is ideal for covering many temporary obligations, such as the outstanding balance on long-term debts
- It may be used as a low-cost option to protect future insurability for an insured whose future need for insurance may change
- It may be used to cover the need for pure insurance protection at a lower cost while releasing funds that may be used for alternative savings or investments

**DISADVANTAGES OF TERM INSURANCE**

Some of the potential disadvantages of term insurance are:

- It is temporary protection only
- It could leave an insured who has become uninsurable without protection if the option to renew or convert to another type of policy is limited to a specified age
- If term insurance is renewable, the renewal premiums advance with age and could become prohibitively expensive at higher ages
- It provides a death benefit only and nothing is returned if an insured lives beyond the insured term

Term insurance contracts have many potential applications when used in lieu of or as a supplement to other policy forms. They may be used to provide temporary protection or to protect insurability when a person is young and insurance needs may change over time. When used as part of a long-range financial plan an insured should supplement the term insurance with some form of savings or investment. Term insurance alone cannot be used to accumulate assets.
PERMANENT LIFE INSURANCE

Permanent life insurance should be used for permanent needs. If a business wants to permanently retain a key employee, a whole life insurance contract is an appropriate employee benefit. If the owner of a business is also a key employee, permanent life insurance is appropriate to cover the eventual loss of that employee-owner. Permanent life insurance would be inappropriate for covering a short-term loan, which is a temporary need.

As with term life insurance, a portion of the premium is used to fund the contract if the insured dies prematurely. A second portion of the premium establishes a fund that will provide a specific benefit whether or not the insured dies. This second portion of the permanent life insurance premium makes up the policy's cash value.

Premiums in the early years of term policies are significantly lower than premiums in the same years of permanent policies. Permanent policies have a cash value, which comes from the difference between the cost of the insurance (what is paid for term) and the amount of premium paid for the permanent policy.

Accumulated values are protected and may not be forfeited. A policy may be surrendered for its cash value, or the cash value may be used to purchase another form of insurance. Policy loans are also available once a policy has accumulated cash value (but face value decreases when policy loans are made).

Because of that initial difference in premium, many clients choose term insurance. But the premium for term insurance will increase as the client grows older, due to the increased likelihood of dying.

Permanent policies, on the other hand, are more expensive than term policies in the early years of the policy, but in the long run the annual premium of term insurance will usually exceed that of permanent insurance.

An agent should show the client the total long-term premium (twenty years, thirty years, or longer) for both term and permanent policies, to assist them in making their decision.

WHOLE LIFE

Whole life insurance provides level premiums and lifetime protection. Two basic types of whole life insurance are straight life and limited-payment life insurance. Straight life insurance provides lifetime protection to age 100 with level premiums paid periodically until the insured dies or reaches age 100. Limited-payment life insurance requires level premium payments for only a specified number of years, although the protection is for a lifetime. All whole life policies have cash values.

Whole life insurance combines insurance protection and savings in a permanent contract that remains in effect for an insured's whole life. It provides a level face amount payable as a death benefit, which consists of the combined value of the declining net insurance protection and accumulating cash value. The policy is designed to mature when the insured reaches age 100, at which time the cash value would equal the face value and become payable as a living benefit.

All whole life policies follow the level premium concept. Under continuous payment straight life policies, premiums are payable until age 100. A whole life policy may also be purchased with a single premium, or according to a limited premium payment schedule which permits the policy to become fully paid-up after a specified number of years.

Whole life insurance is widely used to provide family security because it combines insurance protection and savings, which are the two major elements in the financial plans of most individuals. Term insurance may be used as the "pure protection" underlying an investment plan, or when there is a need for additional protection, and annuities or other investments such as stocks, bonds, or mutual funds may be used when there is a need for greater accumulation of assets.

The insurance element of a whole life policy is virtually identical to the insurance provided by a decreasing term policy. The concepts of "level
"protection" and "permanent insurance" are misleading, because every whole life policy is a combination of a savings plan and an amount of insurance, which is decreasing over time.

Because whole life policies include both insurance and savings, they are often part of a long-range financial plan. They provide a level of safety, since the face value, cash value, and the rate of interest earned on cash value are all guaranteed by the insurance company. In some cases, whole life insurance can be used to provide both life insurance protection and savings for retirement or other purposes. In other cases, it is used as a base, to provide guaranteed security supplemented by other forms of protection and/or savings and investment.

GENERAL CHARACTERISTICS OF WHOLE LIFE INSURANCE

Whole life contracts may be characterized by a number of policy features relating to premiums, death benefits, and other policy values.

Level Premiums

Premiums for whole life policies are level and guaranteed for the life of the contract. Level premiums are achieved by charging more than the actual mortality cost during the early years of the contract, and using these extra premium funds, interest earned on them to compensate for the increasing mortality costs during the later years. The policyholder will pay the same annual premiums for as long as the policy remains in effect. If the insured is still alive at age 100, the face amount of insurance is paid to the policyowner at that time (the policy is said to endow).

Permanent Protection

Whole life insurance is often called "permanent insurance" because the death benefit remains the same throughout a person’s life. In reality, many consumers who purchase whole life insurance use the cash value for retirement income or some other purpose prior to death or policy maturity.

A whole life policy actually consists of a combination of a savings element (the increasing cash value) and a decreasing amount of insurance protection (the difference between the cash value and the face amount). If a whole life policy actually reaches its maturity date, the cash value equals the face amount and the net insurance protection would have declined to zero.

Cash Value

Whole life policies include a cash value, or savings, element in addition to the element of pure insurance protection. This value increases during the life of the contract until, if it is held long enough (usually age 100), it equals the face value and the policy matures (in which case, the cash value becomes payable as a living benefit). A policy may also be surrendered for its cash value, or all or a portion of the cash value may be borrowed, at any time prior to the maturity date. Interest charges are assessed on any policy loans, and unpaid loans are deducted from the death benefit.

A cash value is a fund that accumulates in a whole life insurance policy, which the policyowner can access in several ways while still alive. While the cash value is an integral part of the policy's funding, it is also a nonforfeitable asset of the policyowner. If and when a whole life policy is canceled or surrendered, the owner is entitled to receive the cash value by one of three nonforfeiture options.

USING CASH VALUE

There are many situations in which a ready source of cash is needed. The life contract could be used to store funds at competitive current interest rates until a need arises. If the need never arises, the accumulated cash could be used to fund growth opportunities, or even retirement. Life insurance may be used as a means of providing funds for the purpose of buying out an interest in a partnership or close corporation, or to allow a sole proprietor to retire while the business is operated by an heir.

THE GENERAL ACCOUNT: THE FOUNDATION OF GUARANTEED VALUES

For fully guaranteed contracts (such as whole life insurance), an insurer maintains a general account which consists primarily of safe and conservative investments (such as high grade bonds, real estate, and certificates of deposit). The safety of these investments makes it possible for the insurer to guarantee its policies.
Whole life policies require insurers to operate with a conservative investment perspective. Assets used to support their contractual obligations are held in the insurers’ general accounts. These accounts are comprised of investments that are carefully selected to match the liabilities and guarantees of the contracts they back. These accounts represent the general assets of the company; though they are the foundation of the insurer's policy reserves, they are also subject to the claims of creditors. If an insurer's general account assets ever fail to support its reserve liability, the company is said to be "insolvent" and the assets become subject to the claims of the company's creditors—including its policyowners. To reduce the likelihood of this occurring, insurers typically invest their general account assets in conservative instruments; U.S. Government securities, investment-grade bonds and preferred stock are common.

Whole life insurance contracts guarantee more than just the pure insurance protection. The entire death benefit is guaranteed—including the cash value element. In order to guarantee payment of the entire death benefit under a fixed insurance contract, the policy's cash value is guaranteed to meet contractual expectations. This requires conservative investing by the insurer. This applies to all factors that comprise the policy's funding, including the expected return on investments.

**GUARANTEED NONFORFEITURE VALUES**

During the life of the policy, the cash value continues to accumulate, and is guaranteed to have specific values at the end of each year the policy is in force. These specific, guaranteed values are listed in a table which is a part of the policy.

Usually a whole life policy does not have any cash value at the end of the first or second policy year, due to front-end expenses. After that time, cash value begins to accumulate and it is fully protected. Once an insured has accumulated cash value, it cannot be forfeited. An insured may cash in a policy at any time, by surrendering it in exchange for its cash value.

Upon surrender guaranteed cash values may be taken in cash, may be used to purchase a lesser amount of fully paid-up whole life insurance, or may be used to purchase extended term insurance with the same face value of the whole life policy being surrendered. These options are required by law and are designed to protect the equity that an insured accumulates in a whole life contract.

**GUARANTEED RATES**

The "guaranteed" rates are contractually guaranteed. Because of their long-term nature, they are characteristically low—perhaps 3 to 5 percent compounded annually. Traditional whole life policies rely exclusively on these rates and credit their cash values with the contractually guaranteed rate.

**LEVEL FACE AMOUNT**

The whole life policy provides a fixed amount of protection. The face amount of the policy (the amount payable upon death at any age) is fixed and will not change while the policy remains in effect. As the following diagram shows, an individual who pays premiums every year on the policy is guaranteed $100,000 when the policy matures at age 100. If the insured dies before age 100, the beneficiary will receive $100,000.

<table>
<thead>
<tr>
<th>INSURANCE PROTECTION</th>
<th>65</th>
<th>AGE 100</th>
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<tbody>
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<td>$100,000</td>
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<td>$100,000</td>
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The face value of a whole life policy remains level throughout the insured's lifetime. However, a level face value does not mean level insurance protection. The death benefit is level, but the net amount of true insurance is not. The face amount is a combination of the insurance element (pure protection at risk for the insurance company) and the savings element (the cash value). As the cash value increases, the net protection provided by the contract declines proportionately. The basic structure of a whole life policy consists of an element of decreasing term insurance and an increasing savings account.

The idea of a "level" benefit is something consumers readily understand. Unfortunately, some consumers get confused about the differences between "face amount" and "cash value" - it is not always understood that the death benefit includes the cash value. Many people erroneously believe that both the death benefit and cash value will be paid to the beneficiary.
Since the insurance and savings elements of the contract are, in fact, distinct and mutually exclusive elements, it would be more correct to say that whole life insurance is a “permanent contract” providing a "level face amount" as a death benefit.

TYPES OF WHOLE LIFE POLICIES

Most whole life policies have essentially the same characteristics (maturity at age 100, level face amount, and cash value). Differences in whole life policies usually focus on the different approaches with respect to premium payments.

METHODS OF PAYMENT

There are a number of variations available in the options for whole life premium payments. Under any of these options the whole life policy will still mature at age 100, but in some cases the premium payment period will be shorter.

Life "paid-up at 65" policies require premium payments to stop at age sixty-five. Single premium life insurance has one premium payment and lifelong coverage. In some policies, premium levels may change. Initial premiums are set at a low level and gradually increase for several years until they reach a maximum and then continue at a level amount.

Continuous Premium Whole Life

The most common method of payment is the continuous premium whole life policy, which is also known as a straight life policy. This is the standard whole life contract. It has all of the general characteristics of any whole life policy (level premium, level face amount, cash value, etc.), and its distinguishing feature is that premium payments are required throughout the entire life of the policy.

This type of policy is often referred to as straight life insurance, because it does not deviate in any way from the whole life concept.

Whole life insurance is a "permanent" coverage in that it does not expire without paying benefits, either to the surviving insured or to the beneficiaries. Whole life policies combine the protection of term insurance with a "savings" feature enabling the insured to use the policy to build economic security against the perils of untimely death and superannuation (living beyond earning years). In the whole life insurance illustration below, notice that the portion of the policy representing "pure" protection decreases as the "savings" portion increases.

Whole life insurance, as the name implies, is a contract designed to provide protection over the insured's entire lifetime. There are many types of whole life policies, but the oldest and most common type of whole life policy is ordinary level-premium whole life insurance, or simply ordinary life. This form of insurance is also known as “straight life,” “traditional whole life,” or “continuous-premium whole life.”

Single Premium Whole Life

This is simply a whole life policy with one premium payment (a lump sum amount which, together with the interest it will earn, will be sufficient to cover all future premium payments). The entire cost of this policy is paid up at the time of purchase.

Except for the premium payment, a single premium whole life policy has all of the same characteristics as all other whole life policies.

Single premium payment allows the policy to grow to maturity in the manner represented here.
Single premium life insurance is permanent cash value whole life insurance that is purchased with a single large premium. It requires no further premiums to keep the coverage in force for the life of the insured.

Single premium whole life is the most extreme type of limited payment life where one large premium payment is made. The policy is fully paid up and no further premiums are required. Many such policies have substantial surrender charges if the policy is cashed in during the first few years. Since a substantial payment is involved, it should be viewed as an investment-oriented product.

**Limited Payment Whole Life**

Limited-payment life insurance is a form of whole life insurance in which the premiums are level but are paid only for a certain number of years, after which the policy is paid-up. These policies allow the policyowner to pay for the entire policy in a shorter period of time than under a straight life contract. Common forms of limited payment whole life are 20-payment life (meaning payments spread out over 20 years), 30-payment life, and life paid-up at age 65. These contracts offer a policyowner the opportunity to complete all required premium payments during the income-earning years. Although the policy is fully paid up at the end of this period, it will continue to provide protection and will accumulate cash value until the scheduled maturity date at age 100.

In contrast to a continuous payment straight life policy, a limited payment policy will have relatively higher annual premiums, because premium payments will be made for a shorter time. The shorter the premium payment period, the higher the required premium will be. Limited payment policies will also have a relatively higher initial cash value and a more rapid cash value accumulation for the same reasons.

A **limited pay** whole life policy allows the insured to make payments during prime earnings years.

Limited-payment life remains in force for the insured's entire life, but premiums are paid over a shorter period than other whole life insurance policies. Because the premiums are paid within a shorter period, premium rates are higher than for other types of whole life insurance.

**Indeterminate Premium Whole Life**

These policies are nonparticipating contracts which were developed to compete with participating policies. These policies employ a dual premium concept - a maximum premium and discounts which may reduce the premium. The discounts will vary with insurance company investment performance, but the actual premium charged will never be more than the maximum premium specified in the contract.

**Current Assumption Whole Life**

Current assumption whole life insurance (also called interest sensitive life insurance) is a generic name for a whole life policy in which the cash values and premiums are determined by the insurer's current investment and loss experience. The standard whole life policy with the level premium is modified to reflect changes in interest
rates. Annual premium payments are still required until policy maturity.

The insurance company reserves the right to increase or decrease the premium within a certain range depending on interest rate fluctuations. Premiums might be reduced during periods of relatively high interest rates, and premiums might be increased during periods of low interest rates. These premium adjustments are usually made on an annual basis.

The premium and cash value amounts may change based on the insurer's experience, however there is a minimum guaranteed cash value based on a minimum guaranteed rate of return. The insurer guarantees a maximum annual premium on the policy, but may charge less if the current return on the policy so warrants. The excess interest earned above the guaranteed rate may either lower the premium or increase the cash value accumulation.

**Economatic Contracts**

These policies combine a participating whole life policy with a term rider, and then use dividends to purchase additional paid-up insurance which gradually reduces the term coverage. This allows an individual to purchase a specified amount of total coverage for a lower cost than the premium for the equivalent amount of whole life coverage.

**USES OF WHOLE LIFE INSURANCE**

Whole life insurance has practical applications as a component in individual and family financial planning. Since it includes protection and savings, it addresses the two major components of most people's long-range goals for protection against the financial risk of premature death and providing supplemental funds for retirement income.

A person may choose to use whole life insurance as a part of a financial plan and to supplement it with an additional amount of term coverage. In fact, many whole life policies are issued with term insurance riders.

When the protection portion of the financial plan is adequate, a need to supplement the cash accumulation side of a person's financial plan may also be satisfied with other products, such as an annuity, or alternative savings and investments. These may include certificates of deposit, stocks and bonds, mutual funds and other forms of investment. An individual's needs, resources and willingness to take risks often dictate which tools are appropriate for use in their financial plan.

A whole life policy guarantees that funds will be available whether an insured lives or dies. As soon as a policy is purchased, the death benefit is guaranteed. This provides the security of having time to pursue other goals. If an insured has other long-range financial objectives, such as accumulating assets in real estate or a separate investment portfolio, the immediate security of the death benefit offers peace of mind while these objectives are being pursued. The policy will also accumulate cash value, which can be applied toward these other objectives.

Whole life insurance may also be used to protect estate assets which have been accumulated during life. If an estate is large enough, it may be subject to substantial amounts of estate taxes when the insured dies. Not only does this take away from value of the estate which may be passed on to heirs, it may even force the liquidation of assets in order to pay the required estate taxes. The estate tax and liquidation of assets could mean that much less will be left for survivors. It is quite common for a successful person to purchase a large amount of life insurance later in life specifically to pay estate taxes and to preserve the total size of the estate.

**ADVANTAGES OF WHOLE LIFE INSURANCE**

Proponents of whole life insurance point to the following advantages:

- It is a permanent contract that provides a level face amount as a death benefit for the whole life of the insured
- It has level premiums so the policyowner always knows exactly what the cost of insurance will be and never has to worry about premium increases
- It includes protection against premature death and cash value savings which may be used to supplement retirement income or other purposes
- Its accumulated cash value is protected and cannot be forfeited if the policy lapses or is surrendered
- It provides flexibility because the cash value may be borrowed as a policy loan during emergencies, or may be converted

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into paid-up whole life insurance or extended term insurance

- As an investment, it provides a high level of safety because policy values are guaranteed by the insurance company

The principal advantage of whole life is that it is permanent insurance and can be used to satisfy permanent needs such as the cost of the final illness and burial expenses. The level premium allows the policyowner to always know exactly what the cost of insurance will be, and it offers a form of forced savings. Whole life builds a living benefit through its guaranteed cash value. The cash value can be used as an emergency fund, or cash can be accumulated for specific purposes, such as the children's college education or additional retirement income to the insured.

**DISADVANTAGES OF WHOLE LIFE INSURANCE**

Some of the potential disadvantages of whole life insurance are:

- The premium paying period may last longer than the insured's income-producing years
- The maturity date is not practical, because few people live for 100 years
- The cash value at retirement age may be much less than the face value of the contract
- As an investment it is very conservative, because the guaranteed interest rate is low in comparison to the historical returns on other investments
- It does not provide as much protection per dollar of premium as term insurance

The major disadvantage of ordinary life insurance is that the policyowner might be substantially underinsured after purchasing the policy because ordinary life insurance premiums are generally higher than term insurance until the insured reaches a certain age. Attracted by the savings feature, some policyowners might purchase an ordinary life insurance policy and, as a result, have an insufficient amount of insurance protection.

**SPECIALIZED POLICY FORMS**

Most life insurance policies may be modified by rider or endorsement to attach additional benefits, however, a number of specialized life insurance policies have been designed to apply to some of the more common situations. Many companies sell policies which package different types of coverage in a single contract.

Several life insurance products are based on combinations of the two basic types of life insurance – term and whole life. Most address a specific coverage need, but some are used as marketing tools with little or no relation to a need. The key marketing consideration for the producer in selling life insurance is to match the prospect's need with the right combination of life insurance coverage.

Some specialized policy forms are designed to modify the premium structure rather than the benefit structure. Instead of blending different types of coverage, plans which modify premiums are generally designed for marketing purposes to make life insurance initially more affordable to the buyer.

In a few specialized forms the unique features of the contract are found elsewhere in the policy, such as policies that provide a single amount of insurance that applies to two or more lives.

The names used by different insurance companies for similar types of policies may vary. Individual companies may sell some or all of the policies described in this section, or may include some completely different combinations of coverage in their portfolio of policy forms.

Some specialized life insurance policies are available to meet insurance needs of families with children. Family income and family maintenance policies provide whole life insurance coverage plus an additional amount of term insurance on the life of the head of a household. The term insurance is designed to provide periodic income payments to survivors if the insured dies during the term period. These forms are generally used to provide extra protection during the dependency period.

**FAMILY INCOME POLICIES**

One popular combination policy form is the family income policy. It combines whole life insurance with decreasing term coverage. Both portions of the insurance coverage apply to the head of the...
household. The permanent whole life portion of the policy is usually used to provide a lump sum payment at death, while the term portion of the policy is used to provide monthly income benefits for the surviving family.

Since two types of insurance are combined in the same contract, two time periods affect the benefits. The family income portion of the policy depends upon the decreasing term time period. The term insurance is designed only to provide family income payments from the date of death to the end of the term period. Death must occur during the term period in order for income benefits to begin. Income benefits are usually set as a dollar amount per $1,000 of whole life insurance face value.

Since the base part of the family income policy is provided by whole life insurance, it is permanent insurance and protection is provided for the whole of life (to age 100). If the insured outlives the specified term period for family income coverage, the decreasing term insurance expires, and only the whole life coverage remains until death or maturity, whichever comes first. As with any whole life policy, the insured may elect to surrender the policy for its cash value or begin taking payments under a settlement option at retirement or at any other time.

The family income policy is often used to fulfill the need for higher amounts of insurance coverage while children remain dependent upon the insured. The reason decreasing term insurance is used, is that every year the children are one year closer to independence; the need for insurance protection is reduced. Once the children have grown and become self-supporting, the need for the additional protection for dependent children no longer exists.

FAMILY INCOME

$200/mo X 20 years

20,000 W/L

Effective Date Age 45 Maturity Date

X

FAMILY MAINTENANCE POLICIES

This policy, which is also usually written on the life of a breadwinner, combines whole life insurance with level term coverage.

The family maintenance policy has many of the same features as the family income policy. It is designed to provide a lump sum at death and family income benefits, and pays income benefits if the insured dies before the end of a specified term period. However, the benefit structure is slightly different. It is designed to provide income benefits for a fixed period of time beginning with the date of death provided that the insured dies within the term period.

The primary difference between the family income policy and the family maintenance policy is the length of the income benefit period. Under the family maintenance policy, level term coverage is used to provide a fixed number of installments if the insured dies at any time during the term. Income benefits under this policy are also set as a specified dollar amount per $1,000 of whole life coverage.

There are obvious differences in the benefit structures of the family income and family maintenance policies. Whether one or the other is more appropriate for a particular family's needs may depend more on the insured's priorities, assumptions, and perception of need than on the actual economics of the situation.
One applicant may perceive a need for additional protection only until children become independent. They may assume that after the children are grown, the spouse can return to work full-time and the base life insurance proceeds will provide a sufficient death benefit. This applicant might select a family income policy.

Another applicant with children may feel that the spouse may have difficulty returning to the workforce, and more time will be needed for making transitions and adjustments. This applicant might select a family maintenance policy.

FAMILY MAINTENANCE

<table>
<thead>
<tr>
<th>Effective Date</th>
<th>Age 45</th>
<th>Age 100 Maturity Date</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>$200/mo X 20 years</td>
</tr>
<tr>
<td></td>
<td>X</td>
<td>20,000 W/L</td>
</tr>
</tbody>
</table>

Death at 35
$200/mo X 10 years
then $20,000

FAMILY PROTECTION POLICIES

Many life insurance companies offer a package of life insurance benefits designed to provide coverage for all members of a family under one contract. This type of policy is frequently called a "family policy," "family protection policy" or "family plan". Its purpose is to provide minimal amounts of coverage on each member of the family.

Family protection policies provide whole life coverage on the life of the head of a household, with additional amounts of term coverage on the lives of other family members. Since the amounts of coverage are small, benefits usually cover little more than final expenses and funeral costs. It was originally designed for the stereotyped traditional family of the 1950’s (where the father was the "breadwinner," the mother stayed at home and raised the children, and greater economic emphasis was placed on the father’s life).

The coverage for children begins automatically, usually when they are a few days old, and continues up to a stated age, such as 18 or 21 years.

This form has become somewhat obsolete for families where both parents are working outside of the home. In recent years, there has been an increased awareness of the true economic role played by a "homemaker" (a few thousand dollars of term insurance will not even come close to covering the cost of replacement services, such as child care, house cleaning, preparing meals, etc.). Additionally, for the growing number of families in which both parents are working due to economic necessity, the financial contribution of each parent takes on equal importance. Each working parent usually needs separate life insurance coverage to provide adequately for final expenses, funeral costs, and income security for surviving family members.

The concept of either parent adding a term life insurance rider coverage for dependent children to their policies is still common. As tragic as the loss of a child is, dependent children generally do not contribute to family finances. Final expenses and funeral costs are the primary economic consequences when death of a child occurs, and there is little or no impact on family income. For these reasons, a few thousand dollars of term insurance for dependent children is usually adequate for many families.

FAMILY POLICY

<table>
<thead>
<tr>
<th>Term (Child)</th>
<th>21-25</th>
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</thead>
<tbody>
<tr>
<td>Term (Child)</td>
<td>21-25</td>
</tr>
<tr>
<td>Term (Spouse)</td>
<td>65</td>
</tr>
<tr>
<td>Whole Life (Breadwinner)</td>
<td></td>
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</tbody>
</table>

RETIREMENT INCOME POLICIES

A retirement income policy accumulates a sum of money specifically for retirement, while providing a death benefit if the insured should die prior to that
time. Upon retirement, the policy pays an income such as $10 per $1,000 of life insurance for the insured's lifetime or for a specified period.

These policies are expensive, because of the rapid cash value accumulation required in order to fund the retirement benefits. This makes them more like endowment contracts than whole life insurance.

**JOINT LIFE POLICIES**

Joint life policies are variations of whole life contracts which are written with two or more persons as named insureds. Most commonly, the policy is issued on two lives with the insured amount payable upon the death of the first insured only. However, policies may be found that pay benefits upon each death, in which case the benefit amount for the first death may be reduced. There are even some policies available (usually written for business insurance purposes) that pay a benefit upon the first death and then increase the amount of coverage on the remaining insured or insureds so that the total face value coverage remains the same.

A popular variation of the joint life policy is the last survivor policy. It pays the insured amount upon the death of the last surviving insured. These policies are often used to provide cash to pay estate taxes and other costs after the death of the second spouse.

Joint life policies commonly provide a conversion or exchange privilege for the surviving insured, under which that person has the option to convert to a form of permanent coverage on his or her life following the death of the first insured.

**JUVENILE POLICIES**

The term "juvenile life insurance" is used to refer to any of the specialized policy forms which are specifically designed to cover lives of minors. One type of policy is commonly called a "jumping juvenile" policy because it automatically increases in face value at a given age, usually 21, but the premium remains level. The usual "jump" is from $1,000 to $5,000.

The owner of a juvenile policy is the person who applies for the insurance and is responsible for paying the premiums. Usually, the owner is a parent or grandparent of the insured child. For an extra premium, a payor benefit provision may be added to a juvenile policy under which the premiums for the child's insurance will be waived if the policyowner dies or becomes disabled before the child attains a stated age (usually age 21). The payor benefit is simply a variation of the waiver of premium benefit which may also be attached to the parent's own insurance policy.

**MINIMUM DEPOSIT POLICIES**

This is a whole life type policy with a high cash and loan value, usually available immediately upon payment of the first premium. The initial premium is higher than the premium for traditional whole life insurance, because in addition to covering the mortality cost and expenses, dollars must be immediately allocated to cash value. Such policies were devised in the late 1950s to take advantage of the fact that, at the time, the Internal Revenue Service allowed the interest paid on a policy loan to be deducted in full for income tax purposes.

A prospect could buy such a policy and immediately borrow back the loan value and take a tax deduction so that, in effect, the initial net premium outlay was actually very small. Since that time, however, the IRS has placed restrictions on the interest deduction when a policy loan is made to finance insurance, and the popularity of this form has diminished.

**MODIFIED LIFE POLICIES**

Generally, this type of policy is sold to an individual who desires whole life insurance but who cannot afford to pay the whole life premium during the initial years. By altering the policy structure, the

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individual is given the opportunity to purchase a whole life contract with a reduced premium for the initial three-to-five years of the policy.

Modified life is typically a whole life product which is purchased at a very low premium for a short period of time (three to five years) followed by a higher than average premium for the remaining term of the policy. The policy may be a combination of term insurance for the "modified" period automatically converting to whole life insurance at the later date. The face value remains constant and is not affected by the premium change. The policy does not begin to accumulate cash value until after it converts to a whole life form, because initially the coverage is provided by term insurance.

The modified premium policy has low initial premiums. Once normal premium level is reached, savings begin to grow. Normally savings will not be quite as high as with conventional installment payments to age 65, a commonly used age for comparative purposes.

Graded premium whole life is similar to modified whole life in the sense that initially the premium is very low. Unlike modified life, which has only one increase to a higher level premium for the remaining term of the contract, graded premium policies provide for a series of annual premium increases, usually during the first 5-to-10 years of the policy. At the end of this "step-rated" premium period, the premium remains level for the life of the policy.

Graded premium policies do build cash value, but the amount of the cash value is usually less because of the smaller outlay of premium. Most of the initial premium dollars are allocated to cover the mortality cost of the insurance. The cash value accumulation begins later and has a slower start than under traditional policies. A graded premium policy typically will have very little, if any, cash value during the graded premium period.

The market for modified premium whole life is those who can't afford the initial larger premiums. While their earnings will increase over the years, they are typically not as interested in building cash values as prospects that purchase ordinary or limited premium whole life insurance.

**GRADED PREMIUM POLICIES**

Graded premium policies are designed to allow the policyowner to purchase a version of whole life without the initial cost of whole life insurance. These contracts are aimed at the young individual just beginning a job or career and whose income is expected to increase in future years.

A graded benefit policy has a level premium but an adjustment in the benefit structure at some later date. Unlike some of the other policies which provide for an adjustment in the premium and/or benefits primarily as a sales tool (offering some attractive feature to the insurance buyer), graded benefits are primarily used as an underwriting tool. When a risk is substandard but the negative risk factors are not great enough to justify rejection, a policy may be issued if the insurance company collects some additional premium dollars to cover the higher risk of mortality. There are two ways to do this - charging more than the coverage being provided, or providing less coverage than the premium charge would otherwise indicate.

One technique is to issue a "rated up" policy, where the premium charge is based on an age higher than
the insured's actual attained age. An alternative technique is to issue a "graded benefit" policy, under which a premium is charged for a higher face amount, while the death benefit payable is actually lower during the first five policy years. In this manner, the dollars actually collected are greater than what is needed to cover the amount actually at risk during the early years, and these extra dollars may be set aside to offset the slightly higher risk of mortality.

**SPLIT-LIFE POLICIES**

A split-life policy is a combination of a whole life or a term life insurance contract and an annuity contract. The life insurance has a very low cost, but is available only in combination with the purchase of the annuity. The contract gets its name, "split life," because the insurance may be issued to cover the life of one individual and the annuity may be provided on the life of another (perhaps the beneficiary of the life insurance).

**MORTGAGE REDEMPTION POLICIES**

The mortgage redemption policy or rider is simply decreasing term insurance. The benefit amount of the term coverage is designed to be equal to the unpaid balance of the mortgage loan at any point in time. These policies may be issued independently of the loan, but frequently arrangements for such coverage are made in conjunction with the loan transaction to protect the lender against default. It is often convenient for the purchaser to pay their insurance premium along with their mortgage payment.

**MULTIPLE PROTECTION POLICIES**

Multiple protection policies are combinations of whole life and term whereby the amount of protection is higher in the early years of the policy and less in the later years. For example, the current death benefit may be equal to two times the amount of the benefit at age 65 (double protection). The death benefit payable prior to age 65 is simply reduced to half of its former amount when the insured reaches that age. The additional death benefit prior to age 65 is term insurance.

**DEPOSIT TERM INSURANCE**

Deposit term insurance is a level term insurance policy that has a much higher premium for the first year than for subsequent years. The initial premium is significantly higher than the average premium needed to cover the cost of mortality during the term period. The excess front end premium (the deposit) is then set aside to earn interest, and these dollars (deposit plus interest) will be applied to reduce the premium payments required in the following years. The premium levels are set so that the entire deposit will be exhausted when the final annual premium is paid. This arrangement provides a method of paying a portion of the premium in advance. The initial deposit and interest are used to make up the difference in premium.

**INDEX-_LINKED POLICIES**

Some companies offer policies with face amounts that increase with inflationary trends. The death benefit is usually linked to the Consumer Price Index. Naturally, an additional premium must be charged for the increased amount of protection, and it may be obtained in one of two ways: the insurance company may simply increase the premium when it increases the coverage, or it might make advance assumptions about the rate of inflation and charge a slightly higher premium from the original inception date.

**FLEXIBLE POLICIES**

To some, level premiums, level face amounts, and fixed benefits imply stability and safety. But for others, these same features reflect inflexibility and missed opportunities. This is particularly true when an individual's insurance needs are changing or there are significant changes in economic conditions. In recent decades several new types of life insurance products have been developed and introduced to satisfy consumer demands for more flexibility in terms of premiums, face amounts and investment objectives. The main types of flexible policies available include adjustable life, universal life and variable life insurance.

Flexible life insurance products provide consumers with a wider range of options than traditional
Flexible life insurance products offer the following advantages:

- The convenience of making policy changes without exchanging policies
- The flexibility to change the premium payment or face amount as needs change
- An opportunity to earn higher rates of interest than are available under fixed-return contracts
- Investment returns under variable policies may exceed the fixed returns under guaranteed contracts

Some of the potential disadvantages of flexible life insurance policies are:

- Proof of insurability may be required when an insured increases the face amount
- Policy changes which increase the death benefit could require substantially higher premium payments
- Making many policy changes could cause an insured to lose focus of the overall financial planning goals
- Flexible products were introduced during a period of historically high interest rates, and returns in recent years have fallen far below initial expectations
- The investment element in variable products is not guaranteed, and in many cases there is no guarantee of the amount of the death benefit

Adjustable life insurance allows a policyowner to make changes in the face amount, amount of premium payments, the length of protection, and the type of protection being provided. Adjustments may be made to the basic features of the life insurance policy, but this contract does not offer flexible interest rates or equity investments.

Universal life insurance, it can serve the needs of individuals and businesses just as whole life has done for many years. However, the flexibility of universal life adds a new dimension to fitting the coverage to the changing needs of the insured.

Our financial climate has changed, and life insurance has had to change with it, in large part because of the intense competition for the dollars available for investment. As inflation and interest rates soared, some financial writers suggested that life insurance buyers purchase low-cost term insurance and put their savings where the return was better. They suggested that the client separate the protection and savings elements of a cash value policy: "Buy term and invest the difference!"

The concept of universal life insurance developed in the late 1970s from the idea that the two components of a whole life policy's death benefit - the pure protection and the cash value - could be...
formally separated, giving the policyowner greater control over the funding of the cash value.

Universal life policies enjoyed a surge of success during the mid 1980s when high interest rates were widely available. Sales of universal life products grew at the expense of whole life sales. Since that time, interest rates have dropped dramatically, and universal life sales have fallen while whole life sales recovered much of their former market share.

Universal life insurance is a flexible premium policy that has an investment feature and separates the protection, savings, and expense components. The policy has a guaranteed minimum interest rate and guaranteed cash values. The policy also provides for the crediting of the cash value account with excess interest based on a higher current market rate of interest. Universal life insurance allows adjustments in the benefit and premium amounts, and also offers competitive interest rates on cash value. The distinctive feature of this contract is the variable rate of interest is provided.

Universal life is widely used as a funding vehicle for split dollar and salary continuation/deferred compensation plans. The flexibility of the contract and the high potential returns make the policy appealing to both the employee and the employer.

Universal life insurance has become popular in recent years. Universal life policies are frequently sold as an investment that combines life insurance protection with savings. The policyowner has a cash value account that is credited with the premiums paid less a deduction for the cost of the insurance protection and expenses charged. The balance in the account is then credited with interest at a specified rate. If the policy is surrendered, the cash value account may be reduced by a surrender charge.

One of the potential disadvantages of universal life policies is that they may not perform as expected. When originally introduced, some companies promoted them by using long-range projections of very high interest rates (12%-to-15%). Rates have now fallen so much that actual returns will be considerably lower. Even though agents and companies may warn that projections are not guarantees, overly optimistic projections can only lead to consumer disappointment when actual results are less favorable. Agents must be extremely careful to provide reasonable expectations.

**INFLATION**

Universal life insurance was developed in response to the relatively low interest rates (generally 3 1/2-5%) earned by traditional whole life insurance cash values, which made the whole life product less attractive during periods of high inflation. In order to be more competitive, insurers introduced universal life policies which might pay higher interest rates (such as 8%, 10% or even 12%) during inflationary times. These policies also provide greater flexibility, because they allow policyowners to adjust the death benefits and/or premium payments.

The effect of inflation on insurance face amounts and savings is well-documented. A policy having a fixed death benefit, purchased now, may very well be wholly inadequate 20 years from now. Also, the guaranteed interest rate in such fixed death benefit policies often falls short of keeping pace with current interest rates.

Universal life, however, can provide the flexibility to cope with inflation, and does this in large measure automatically because of the tax-deferred accumulation of cash values at current interest rates. Should the policyowner wish to increase the death benefit, it may be done, although proof of insurability may be required. Universal life insurance features competitive current interest rates to help keep pace with inflation.

**CASH ACCUMULATION FOR RETIREMENT**

People who plan for retirement really have two problems: they must provide life insurance protection for their beneficiary now, while at the same time, accumulate cash value for the future. Whole life insurance will accumulate cash value. However, few nonparticipating policies can match universal life. Participating policies may be able to achieve good returns but do not have the same premium flexibility as universal life. A whole life policyowner can only withdraw any dividend credits. To get more money out of this type of policy, either the insurance coverage would have to be surrendered or policy loans would need to be made, on which interest must be paid or accumulated. In addition to these methods of obtaining funds, a universal life policyowner can also withdraw the cash value without paying interest or surrendering the policy.
FAMILY

Universal life can be molded to the changing needs of the family, offering flexibility and versatility. The policy owner really designs the universal life policy based on his or her needs and ability to pay. This is possible because this unusual life insurance policy offers the policyowner the opportunity to change the policy in any or all of the following ways:

- Increase or reduce the amount of insurance protection.
- Increase, reduce, or even suspend premium payments.
- Pay in extra money to enjoy the tax-deferred build up of cash value.

Through the flexibility that these versatile features permit, the policyholder can use the policy to meet most, if not all, of his or her present and future life insurance needs.

BASIC CHARACTERISTICS OF UNIVERSAL LIFE INSURANCE

Universal life is a flexible-premium, adjustable-benefit life insurance contract which accumulates a cash value. “Flexible premium” means that, subject to certain limitations, the policyowner may pay more or less than the premium stated in the contract.

Although there are many variations of universal life contracts, most have an initial required premium. Sales and administrative charges are deducted from the premium, and the balance goes into a fund. Each month, a charge that covers the difference between the cash value and death benefit amounts is deducted for pure term insurance. The balance of the premium earns at least the rate of interest guaranteed in the contract. If the insurer earns excess interest, additional interest credits can be added to the cash value. When interest rates are high, relatively high interest returns have been credited.

In addition to a flexible premium, the universal life contract also provides for an adjustable death benefit. Subject to certain limits, the policyowner may either increase or decrease the stated death benefit. Neither an increase nor a decrease in the death benefit requires the issue of a new policy. However, a policy owner may have to show evidence of insurability if an increase in the death benefit is desired.

Universal life insurance has several basic characteristics:

- Separation of protection, savings, and expense components
- Guaranteed minimum rate of interest
- Considerable flexibility
- Partial cash withdrawals option

First, there is separation (“unbundling”) of the protection, savings, and expense components under the policy. The policyowner receives an annual disclosure statement that shows the premiums paid, death benefit, expense charges, interest credited to the cash value account, and cash surrender value.

Second, there are two interest rates credited to the cash value account is specifically stated. There is a current interest rate, which is higher than the guaranteed rate and fluctuates with the market. A guaranteed minimum interest rate is also stated in the policy, such as 4 or 4.5 percent. The interest rate credited to the cash value account can never be less than the guaranteed rate.

In addition, universal life insurance provides considerable flexibility. Premiums can be decreased, increased, or skipped as long as the cash value account is sufficient to pay the mortality costs and expenses; the death benefit can be increased (with evidence of insurability); the policyowner can add to the cash value at any time subject to any insurer restrictions; policy loans are permitted; and certain insureds can be added to the policy. If the cash value is insufficient to pay the mortality charge, then the policy owner would have to pay an additional premium to avoid lapse of the policy.

Partial cash withdrawals can be made. A surrender charge or transaction fee may be imposed for each withdrawal. Unlike a policy loan, a partial cash withdrawal does not obligate the policyowner to pay interest on the funds withdrawn or to repay the insurance company. The withdrawal simply reduces the cash value account. Funds withdrawn can be restored through voluntary additional premium payments.

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**USES OF UNIVERSAL LIFE INSURANCE**

Universal life insurance is appropriate for policyowners who want both an investment vehicle and life insurance protection in one policy. It is also appropriate for policyowners who want flexibility in their life insurance program as financial circumstances change over time. Premiums can be decreased or even eliminated by policyowners who are in tight financial times. Premiums may also be increased by policyowners in order to accumulate higher cash values for retirement purposes. Universal life insurance can be also used to save money for specific financial goals, such as a down payment on a home, the children's college education, or retirement income.

One disadvantage of universal life insurance is that because of the flexibility that allows policyowners to reduce or eliminate premiums, some policyowners might not be firmly committed to pay regularly. As a result, the policy might lapse due to insufficient cash value to keep the insurance in force.

**UNIVERSAL LIFE DEATH BENEFIT OPTIONS**

There are two forms of universal life insurance. The first type (A) has an initial level death benefit; as the cash value increases, the amount of pure insurance protection declines. The second type (B) has an increasing death benefit; the death benefit is equal to the face amount of insurance plus the cash value. As the cash value increases, the total death benefit also increases. A higher premium is charged for the second type of policy.

Option A provides a level death benefit, and Option B provides an increasing death benefit. Under either option the death benefit is received free of income tax by the beneficiary.

At any specific age the insured is purchasing more pure insurance protection under Option B than under Option A. The insured will incure a greater cost for insurance under Option B than under Option A.

### Option A - Level Death Benefit

Under Option A (also called Option 1) the death benefit remains level and equals the policy's face amount. As the policy's cash value increases, the net insurance protection decreases, but the face value stays the same. Due to the higher potential interest rates that may be credited to the account, if the cash value increases to an amount that exceeds the policy's face amount, then the death benefit will automatically be increased. Under current tax laws, if the universal life policy is to maintain its status as life insurance and thus provide a tax free death benefit, there must be a degree of mortality risk (pure protection) until the insured's age 95.

If the excessive funding would cause the policy value to accumulate too rapidly—so that it would mature before age 95, the policy would no longer meet the Internal Revenue Code's definition of "life insurance" and would immediately lose its tax advantages. To prevent this from happening, insurers continuously monitor each policy to make sure the account value does not infringe upon the corridor of pure insurance protection required by the Code.

### Option B - Increasing Death Benefit

Option B (also known as Option 2) provides for an increasing death benefit equal to the policy's face amount plus the accumulated cash value.
Option B does not risk a corridor problem since there will always be pure insurance protection. With Option B, the death benefit is always equal to the level amount of pure insurance protection and the policy's cash value.

**Sum Insured Option Provision**

The availability of two optional types of death benefit enhances the flexible character of universal life insurance. Virtually all UL policies permit policyowners to switch from Option A to Option B and vice versa with few restrictions. A common technique used to maximize the insurance opportunity calls for selecting Option B (increasing death benefit) initially, and switching to Option A later.

The policyowner's right to change between Option A and Option B is covered in the sum insured option provision. Most policies limit such changes to once per year.

- If the change is from Option A to Option B, the face amount of the policy will become equal to the pure insurance protection from the prior Option A. To that will be added the policy's account value (which doesn't change when a policy is switched from one option to the other) to yield the full death benefit.
- If the change is from Option B to Option A, the face amount will become equal to the full death benefit under the prior Option B (of which a portion is the account value); from then on, the pure insurance protection will decrease.

When a UL policy changes from an Option B death benefit (cash value plus level amount at risk) to an Option A death benefit (level death benefit with increasing cash value and decreasing amount at risk), the reduced future benefit under the policy may require an immediate reduction in cash value to bring the policy into compliance with the cash value accumulation or guideline premium/cash value corridor test.

**CASH VALUE**

An important feature of universal life is the tax-deferred accumulation of cash value. From each premium paid by the policyowner, a charge, or "load," is deducted to cover sales and administrative expenses. The remainder of the premium goes into a cash value account. From this cash value account the amount needed to pay the mortality charge for the desired death benefit is deducted, usually on a monthly basis and at current term rates. If the policy owner pays more premium than is required to provide the desired death benefit plus other costs, the universal life policy will accumulate cash value.

Premiums paid into a universal life policy earn a current rate of return which can be substantially greater than traditional permanent life insurance policies, and taxes on such earnings are postponed until the policy owner surrenders the policy. If the policy is held until the insured's death, amounts paid as death benefits will never be subject to income tax.

At any time, the policy owner can make additional contributions above and beyond the regular premium payments, and in doing so can substantially increase the cash value in the policy. These contributions may be made as long as the total premiums paid and the cash value accumulated do not exceed the guideline limits established by the tax definition of life insurance.

The current rate of return is what the insurance company is currently paying. This rate can go up or it can go down. But it cannot drop below the company's guaranteed minimum rate of return.

The Tax Reform Act of 1984 established a definition of life insurance which extended to all life insurance contracts including universal life. To meet the definition of life insurance, a contract must satisfy either of two tests in regard to premium or cash value. The policy's failure to meet either of the two tests will result in income taxation of both the annual earnings on the cash value and the death proceeds paid to the beneficiary.

The corridor rules require that if a policy is to meet the definition of life insurance, there must be a minimum amount of pure insurance protection until at least age 95 (and to no later than age 100). At any age until 95, a stipulated percentage of the policy's death benefit must consist of pure insurance protection as opposed to cash value. If the policy matures (or "endows") any earlier than 95, the contract is no longer considered life insurance under the Internal Revenue Code, and it immediately loses its tax advantages.
Provided the extra premium contributions remain within established IRC limits (under the so-called corridor rules), universal life policyowners may intentionally exceed the target premium (as the minimum required premium amount is sometimes called). If the excessively funded cash value reaches the corridor limit (the "guideline premium amount"), the death benefit is raised to accommodate the richer cash value. Consequently, the net amount at risk remains unchanged.

The corridor rules are primarily a concern only with universal life Option A. Option B policies cannot violate the corridor rules because the pure insurance protection remains level (and the death benefit face amount automatically adjusts upward with the increasing cash value).

The guideline premium is the maximum amount that could be accepted by the policy without violating the Internal Revenue Code corridor rules. Most insurers also have an administrative practice of not accepting premiums above the amount that would cause the policy to be considered a modified endowment contract.

**ADJUSTMENTS TO THE CASH VALUE ACCOUNT**

Two adjustments are made to the cash value account, usually on a monthly basis. The first adjustment is a charge against the account to pay the cost of the desired insurance coverage at the current term rates. If the cash value account is sufficiently large so as to provide for the monthly cost-of-insurance deductions, the policy will remain in force even though premiums are not being currently paid. Premium payments could be skipped for months or even years. If the cash value is insufficient to pay the mortality charge, then the policyowner would have to pay an additional premium to avoid lapse of the policy.

The second adjustment to the cash value account is a credit of interest at the current rate. The "current rate" consists of two parts: a guaranteed interest rate (guaranteed for the life of the policy, and usually fairly low, and excess interest earned by the insurer. Current interest is equal to guaranteed interest plus excess interest. Excess interest is not guaranteed and may vary widely depending on economic conditions.

Some companies will guarantee their current interest rate for a full year. Some companies will choose a shorter period of time, while still others will not guarantee their current interest rates for any particular period of time, thus allowing them the flexibility to react quickly to fluctuating interest rates. Current interest rates are sometimes tied to a recognized index, such as the discount rate for 91-day U.S. Treasury Bills.

Not all of the cash value account receives interest at the current rate. Some policies do not pay excess interest on the first $1,000 in the cash value account.

In the first year, other charges may also be made in addition to the two just mentioned in a front-end load policy. Some insurers levy a monthly charge of a few cents to a dollar or more per thousand of death benefit. Other companies make a flat monthly charge. It is not unusual to find a combination of charges made in the first year which include:

- A charge of 71/2% to 10% of the premium.
- A load generated by not paying excess interest on the first $1,000 of cash value.
- A monthly charge per $1,000 of death benefit.
- A flat monthly charge of $20 to $50 or more.

One of the advantages of universal life is that the policy owner is made aware of all the charges and credits made with respect to the contract. Universal life contract holders are furnished with an annual report itemizing the current status of their policies.

The annual statement for a universal life policy illustrates premiums paid, expenses charged, cost of term insurance, and the interest credited to the cash value.

**Calculating the Cash Value**

The universal life insurance policy cash value at any time is a function of the dynamic forces that act on it. Those forces include:

- Premium payments made by the policyowner
- Interest credited by the insurer
- Cost of insurance deducted by the insurer
- Monthly expenses deducted by the insurer
The cash value can be depicted as a **bucket of money** to which premiums and interest are added and from which COI and expense deductions are taken.

![Diagram of cash value components]

Because the policyowner has control over the elements of the universal life insurance policy, it can take on the characteristics of many other policy types, depending on the level of premiums paid relative to the death benefits the policy provides. It can look like a single premium paid-up policy or a pure term policy—or virtually anything in between. It can take on the characteristics of a limited payment life insurance policy, an endowment policy or an increasing premium policy. The flexibility exists because the insured controls the amount of the premium paid and its frequency. And, it is the premium payments that have the most significant effect on the policy’s cash value.

**PREMIUM AND CONTRACT CHARGES**

The unbundled character of UL means that all policy charges are visible to the insured.

Charges fall into three general types:

- Deductions from each premium
- Deductions from the policy account value
- Deductions upon policy surrender.

**Premium Charges**

The following charges may be deducted from each premium payment:

- State premium tax charge. This charge, usually around 2 percent to 3 percent of each premium payment, is generally a fixed percentage that represents an average of all state premium taxes.
- Federal PAC tax charge. In 1990, the Internal Revenue Code was amended to alter the way insurers can deduct policy acquisition costs. Most insurers today pass on the cost of the so-called PAC tax in the form of a premium charge, which is usually around 1 to 2 percent.
- Sales charge. Commissions, advertising and printing costs are recovered through a sales charge—usually around 4 percent to 6 percent—deducted from each premium.

**Account Value Charges**

Most UL policies deduct certain charges, usually monthly, from the policy's account value, including:

- Issue charge. Usually deducted only during the first policy year, this charge (generally stated as a dollar amount, such as $20 per month) compensates the insurer for expenses incurred in connection with the issuance of the policy (other than sales), including medical examinations, underwriting and establishing policy records.
- Maintenance charge. Unlike the issue charge, which is usually deducted during the first policy year only, the maintenance charge is deducted over the life of the policy. Charges may range from $5 to $10 per month.
- Insurance charge. This is the mortality charge and is based on the insured's attained age and the amount of pure insurance protection (amount at risk), plus an extra charge if the policy was issued on a substandard basis.
- Charge for optional benefits riders. Contract owners who elect optional benefit riders will pay for this increased protection through a monthly charge.
- Asset management fee. This daily charge covers the cost of managing the subaccounts within a separate account and will vary from one subaccount to another.
- Mortality and expense risk fee. This charge, also deducted daily, covers the risk that the insured may suffer an extremely premature demise or that the actual cost of administering the policy will be greater than was projected.
Surrender Charges

A universal life contract may be surrendered for its cash value whenever the policyowner wishes, although a flat surrender charge is usually applied. Surrender charges typically decrease over some time period, such as ten to fifteen years.

GRACE PERIOD

Under a universal life insurance contract the cost of insurance is deducted from the cash value account. When the cash value account no longer contains enough money to pay the next cost-of-insurance deduction, coverage under the contract expires. However, there is a grace period.

The Universal Life grace period stipulates that, beginning on the "date of default," the contract owner will be allowed 61 or 62 days to pay enough premium to cover all overdue charges and keep the policy funded at a minimum level.

During this time the policy owner must make a premium payment to keep the policy in force. If this is not done, coverage ends. At this point there would be no nonforfeiture options since there is no cash value left to forfeit.

FRONT-END AND BACK-END LOADS

Depending on policy design, universal life policies may have front-end sales loads, back-end sales loads, or some combination of the two. The sales loads are the charges that the insurance company levies against the values in a policy to cover its own expenses, including the agent's sales commissions.

In a front-end load, the part of the premium charged as a sales load would be deducted and the balance would go into the cash value account. Front-end load charges generally range from about 7 1/2% to 10%. Many insurers also charge a flat dollar amount of several hundred dollars at the time of policy issue.

The back-end load policy was designed to overcome the principal drawback of the earlier front-end load policies: the consumer did not have many dollars earning interest in the policy during the early years of the contract. The back-end loads usually take the form of service charges for withdrawals from the policy, for policy surrenders and for coverage changes. And instead of the flat first-year charge, insurers will levy penalties for policy cancellation. These penalties are usually highest in the early years and then decline gradually over time.

POLICY LOANS

Universal life provides for cash value loans in the same way that any permanent plan of insurance does. If a loan is taken, it is subject to interest and if unpaid, both the interest and the loan amount will reduce the face amount of the policy. Also, excess interest is usually not paid on cash value amounts borrowed under a universal life contract.

WITHDRAWAL OR PARTIAL SURRENDER

Many universal life policies will also permit a partial withdrawal or surrender from the cash account, which is not treated as a loan. A partial surrender is not subject to any interest and will simply reduce the total cash value in the account. If this withdrawal is later repaid, it will be treated as a premium subject to any sales load that the policy may have.

The death benefit, reduced when the withdrawal is made, is not automatically increased if the cash withdrawal is replaced at a later date. The insured would need to specifically request an increase in the death benefit, and the company may require evidence of insurability.

When the distribution is made to the policyowner, he or she recognizes ordinary income to the extent there is gain in the contract.

A 1986 law change resolved the tax issues related to partial withdrawals as follows:

1. In the first five years, the forced-out portion of a distribution is taxable to the extent there is gain in the contract. This will typically occur where the aggregate premiums paid approach the guideline premium limit.
2. In policy years 6 through 15, the portion of a force-out distribution that is taxable is determined by reference to the corridor percentages. This will typically occur in the longer policy durations when the policy has been substantially funded.
3. Partial withdrawals made after the first 15 policy years have elapsed will be considered a return of capital first, and then interest.

Policy loans are not treated as distributions under these rules.

As a general rule, policy loans should be used in policy years 1-15 for policies that are substantially funded. In policy years 16 and after, partial withdrawals could be made until the taxpayer's basis has been fully recovered. Then, the taxpayer could go back to policy loans to keep subsequent distributions from being currently taxed.

Cash value withdrawals are given favorable tax treatment. This approach to treating withdrawals is known as first in-first out (FIFO) treatment: that which is first put into the contract (premiums) is considered to be withdrawn first.

Withdrawals cause a reduction in policy cash values and death benefits which may be taxable. For policies which are MECS, there will generally be an additional 10% income tax penalty for early withdrawals prior to age 59 1/2.
VARIABLE LIFE INSURANCE

Variable life insurance was developed in response to the low returns earned by traditional cash value policies. The policy has two elements - death protection and a savings/investment element. However, instead of the cash values being linked to interest rates, they are backed by equity investments and securities and are not guaranteed. Variable life insurance generally has the following characteristics:

- A guaranteed minimum death benefit (the actual death benefit may be higher and will vary with the success of the investments)
- Cash values which are not guaranteed (these vary with investment success and may change daily)
- These contracts are regulated as securities

Variable life insurance is a life insurance policy in which the face amount of insurance and cash value vary according to the investment experience of a separate account maintained by the insurer. The policy provides permanent protection with level premiums that are invested in common stocks, bonds, or other investments. Variable life insurance is appropriate for policyowners who want some protection against inflation in the long run in their insurance program.

Variable life insurance offers a hedge against inflation by establishing an investment account rather than a cash value account. Premiums may be fixed or flexible. Death benefits and the cash or investment value may depend upon the performance of the equity investments. This product is regulated as a life insurance product and as a security investment. Agents must have dual authority from state and federal regulators to sell this product.

According to the Model Variable Life Insurance Regulation of the National Association of Insurance Commissioners (NAIC), variable life insurance is a policy in which the death benefit varies with the investment experience of a segregated investment account maintained by the life insurance company.

According to the NAIC Model Variable Life Insurance Regulation, all variable life policies share three important features:

- Although the policy will provide variable death benefits and policy values, the premiums paid by the policy owner will remain level.
- It is required that the death benefit be greater than or equal to the original face amount of the policy.
- Coverage must be permanent.

Variable life insurance, first introduced in this country in the mid-1970s, with its minimum guaranteed death benefit and possibility of escalating benefits, it presents an attractive alternative to fixed benefit products.

Because the values in a variable life contract depend on the performance of an investment account, there is an inflation hedge only to the extent that the underlying investments keep pace with (or outperform) the general movement in prices. Client must be advised that there are no guarantees on the performance of the investment vehicle used to create and support the cash value of the policy.

Variable life insurance is not for everyone. Clients who are uncomfortable with the investment risks characteristic of variable contracts may not be suitable candidates for this product. Financial representatives have a responsibility at both the state and federal level-to ascertain the suitability of any financial or insurance product (but, especially variable contracts) before recommending its purchase to clients.

Compared to other permanent life insurance policies, variable life policies involve some risk. In
periods of failing stock and bond prices or during a recession, the variable policy presents a less desirable plan than the other types of permanent life insurance. Producers should not sell variable policies to clients not willing to take this financial risk with their life insurance.

THE REGULATION OF VARIABLE LIFE INSURANCE

Premiums paid for variable life insurance contracts are placed in the insurer's separate account, consisting primarily of investments which are not guaranteed, so there is considerable investment risk to the policyowner. Due to this element of investment risk, the federal government has declared that variable contracts are securities and are regulated by the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD), and other federal bodies. Variable life insurance is also regulated by state Insurance Department as an insurance product.

As a result of the dual regulation of variable insurance products, agents selling variable life insurance must be registered with the NASD by passing the appropriate licensing exam (usually Series 6 or Series 7), and must also be licensed on a state level to sell life insurance. In some states, life agents are required to obtain a separate variable contracts license.

The principles underlying mutual funds and separate accounts are nearly identical. Like mutual funds, separate accounts are considered "securities" due to the direct pass-through of investment performance from asset to investor. Both mutual funds and variable contracts are regulated by many of the same federal securities laws as general securities.

Regulations

Practically all of the regulatory requirements facing variable life contracts revolve around the pure investment risk included with these products.

Most securities regulations were developed in response to the trading abuses that turned into the infamous stock market crash of 1929 and the Great Depression that followed it.

The Act of 1934 created the Securities and Exchange Commission (SEC) to oversee the industry and set up regulations to govern the conduct of people engaged in the secondary trading of securities.

This act was amended in 1938 by the Maloney Act, which provides for the establishment of a self-regulatory body to help police the industry. The National Association of Securities Dealers (NASD), regulates over-the-counter trading.

Today, anyone wanting to sell securities, including mutual funds and variable contracts, must first be registered with the NASD. Mutual fund and variable contract sales require a Series 6 (Investment Company / Variable Contracts Limited Representative) registration, while a Series 7 (General Securities) registration is required to sell all levels of securities.

Because variable life is a form of life insurance, a life insurance license is also required to sell these particular policies. States vary as to their specific requirements. Some require a separate variable contracts license, while others permit variable contract sales as long as the financial representative has a valid life insurance license and is properly registered with the NASD.

To prevent agents from misleading the public about the possible returns that can be expected with variable life insurance, during sales solicitations. Variable life illustrations may not be based on projected interest rates greater than 12%. This prevents both the agent and the policyholder from assuming excessive and unrealistic rates of return. A variety of policy performance illustrations at different rates (such as 8%, 10% and 12%) would be the preferred method for clearly explaining variable life products. Agents should also stress that rates are not guaranteed and that historical performance may not be duplicated in the future.

EXTRA RISK DEMANDS EXTRA CARE

The characteristic investment risk of variable contracts obligates all parties involved with the creation, marketing and sale of these products to be completely forthright in their dealings with the public.

SEC approval of a prospectus means only that the SEC has approved the manner in which the product
was constructed and presented to the public—not the inherent quality or worthiness of the investment. Your role is to disclose all the information needed by the average investor to make an informed decision, not warranty the future performance of the separate account. Provided every effort is made to comply in good faith with state and federal disclosure requirements, producers should not feel responsible for the investment performance of the separate accounts selected by their clients.

State and federal securities laws emphasize the importance of making sure consumers have a clear understanding of (1) the general nature of variable contracts, (2) the specific nature of life insurance (especially whole life) and (3) the unique characteristics of the product being recommended. These issues are addressed in two basic ways: determining that the product is suitable for a client and fully disclosing all pertinent information about the product to the client.

**Suitability of Variable Contracts**

The issue of "suitability"—common sense dictates proper conduct in selling variable contracts.

- Perhaps most important, determine first that the need exists for life insurance or annuity protection before recommending a variable contract.
- Never guarantee that which cannot be guaranteed.
- Make sure your client understands the risk inherent in any securities-based investment.
- Recommend specific separate accounts that conform to the client's planning objectives and risk tolerance profile.

Suitability is addressed primarily at the state level. Most states require companies selling variable life insurance (including variable universal life) to formally adopt a statement of suitability. This standard must be respected by all employees, board directors and producers (agents and/or brokers) of the company. The suitability standard must be applied in every sale. No variable life insurance contract may be sold or issued unless the client meets the standards set forth in the statement of suitability. This requirement dovetails with the regulations found in most state insurance codes requiring producers to determine the suitability of life insurance for the prospective client.

From a state's perspective, "suitability" means the purchase of variable life insurance is reasonably consistent with the insured's objectives and needs as determined by his or her age, family situation, financial condition and other relevant information reasonably available to the insurer or producer.

Suitability is also determined by the likelihood that the insured will persist with the policy for a certain length of time. In determining whether suitability standards are being observed, state securities administrators review lapse rates for variable life policies during the first two policy years. Lapse rates significantly higher than expected (usually determined by comparing lapse rates among different companies) may indicate that policyowners are not being properly screened for suitability. (Instances where a policyowner exchanges a variable life contract for a conventional whole life contract are not considered lapses.)

Underlying the issue of suitability is the producer's basic responsibility to make sure his or her clients understand (1) the fundamental investment risk characteristics of variable life insurance, (2) the relation between investment risk and reward, (3) their personal risk tolerance level and (4) the general nature of life insurance. The decision whether to buy conventional or variable life insurance, and the selection of separate accounts, should be made only after a thorough review of each of these issues.

Determining a prospective client's risk tolerance is an important responsibility of financial representatives selling variable contracts. The suitability of one separate account relative to another will depend on the buyer's risk tolerance as well as the separate account's investment objective. Most companies provide their financial representatives with assistance in helping them determine the risk tolerance of their clients.

Like mutual funds, separate accounts offer different investment objectives. One account may promote capital growth, while another may promote income. Different objectives usually involve varying degrees of risk. An aggressive growth separate account may be appropriate for long-range investment horizons, but its volatility makes it questionable for meeting short-term (five years or less) objectives.

No financial instrument fits every situation, however variable contracts fit a great many situations, provided several conditions are met:
• A need for the basic insurance protection must exist.
• The client must understand the long-term nature of all life insurance and annuity contracts.
• You and the client must be familiar with the client's investor profile (which you will likely prepare).
• The client must understand the unique nature and characteristics of the variable concept in general and the recommended product in particular. This helps achieve suitability, and usually makes for a more committed client.
• The client must understand the basic objectives of each separate or subaccount option, and realize that no selection is truly risk-free.

**Full Disclosure**

In addition to suitability standards, most states require that life insurance companies provide all life insurance applicants with a generic Buyer's Guide to Life Insurance and a product-specific Policy Summary, which together explain the general nature of life insurance and the specific characteristics of the policy being recommended. Usually, these documents must be presented when the application is written, and in no instance later than the payment of the first premium.

At the federal level, the Securities Act of 1933 requires that a prospectus be given to the prospective variable life buyer before or at the time of the sale, it discloses the nature of the investment, expense and surrender charges, the investment objectives of each available investment fund, benefit provisions and so on.

The intent of these disclosure requirements is to foster a better understanding by the client of the unique risks and opportunities of variable contracts.

The application form also serves the disclosure need. In addition to the standard information covered in any life insurance application, those for variable life must contain:

• A statement, signed by the applicant, indicating that he or she understands that the death benefit may fluctuate in value but will never be less than the minimum guaranteed face amount;
• A statement, also acknowledged by the applicant, that the policy's cash value will fluctuate in direct response to the performance of the underlying separate accounts; and
• Questions (and answers) that will aid the applicant in determining the suitability of variable life insurance.

Suitability and disclosure are especially sensitive issues with respect to variable contracts as compared to their conventional counterparts. Applicants who do not understand the variable nature of this product, the relationship between risk and reward and the operation of the separate accounts (including the difference in each account's fund objectives) cannot be considered suitable candidates for a variable life insurance contract.

**HOW A VARIABLE LIFE INSURANCE CONTRACT WORKS**

In most respects, variable life insurance contracts function no differently than conventional policies. But variable life also has some features that make it unique, all related in some way to the contract's separate account operation. Some important provisions and features of a standard variable life contract will illustrate how it compares with its conventional fixed interest counterpart.

Variable life does not "unbundle" the savings and protection elements of a policy the way universal life does. The cash value of the policy is invested in a side fund, and the cash value amount will vary directly with the performance of this side fund. There is no minimum guaranteed cash value.

Premiums on variable life are fixed and level over the contract period. Variable life policies do not pay dividends. The portion of each premium remaining after expense and mortality charges are deducted, and most variable life policies give the consumer a choice of investments: common stocks, money market instruments, corporate bonds, U.S. government securities, etc. The consumer can also switch among the various investment options at regular intervals.

**Premium Payments**

Variable life policies may be issued as scheduled premium variable life policies which require a periodic level premium be paid to keep the policy in
force, or as flexible premium variable life policies which do not require fixed premium payments.

**SCHEDULED PREMIUM VARIABLE LIFE**

This policy requires a periodic level premium be paid to keep the policy in force. Because a specific premium will be paid, this type of variable life provides a guaranteed minimum death benefit equal to the initial face amount of the policy. Excess death benefits may be paid depending on the performance of the policy's separate account. If the portfolio of common stock in the separate account does well, then the variable life policy will perform well. However, the policy owner is guaranteed a minimum death benefit regardless of the performance of the separate account. The cash value of the scheduled premium variable life policy is not guaranteed. The values are solely dependent upon the performance of the separate account. Due to this factor, any cash value loan is usually limited to 75% of the policy's available cash value.

**FLEXIBLE PREMIUM VARIABLE LIFE**

Flexible Premium VL provides the flexibility to adjust premiums in combination with investments that are a hedge against inflation. The performance of the policy is solely based on the performance of the separate account. There is usually no guaranteed death benefit because of the flexible premium concept.

**Charges and Expenses**

Both conventional and variable life insurance charge policyowners for expenses. Conventional policies generally deduct charges from the gross premium. The gross premium is based on three factors: a charge for the insured's mortality risk, a credit based on an assumed rate of interest and a charge for expenses. Variable policies also deduct expense charges from gross premiums, but most charges are deducted from the cash value.

**Deductions from the Cash Value**

Deductions of charges and expenses from the cash value reduce the investment return realized by the contract. The deductions often include three separate forms of mortality risk fees, including the standard mortality, or insurance charge; a charge for mortality risk; and a charge to cover the guaranteed minimum death benefit.

Other fees deducted from the separate account include investment management fees (covering the services of the separate account fund managers, normally less than 1 percent) and possibly a monthly contract issue charge. Some policies also charge an expense risk fee, covering the risk that the actual cost of issuing and maintaining policies will be greater than anticipated.

Variable life policies are not exclusively investment instruments; first and foremost, they are life insurance contracts, and like all life insurance contracts, they must cover the cost of the benefits they provide. Due to these costs, the return on the funds invested in a variable life policy will never equal that of a similar investment that does not provide a life insurance benefit (such as a mutual fund).

**Monthly Revaluation of the Cash Value**

While the separate account value changes daily, the cash values it supports need to be revalued only once per month. Between valuations, the cash value (for loan, surrender and nonforfeiture purposes) is set at the previous valuation amount. Some companies revalue their policies’ cash values more frequently. This represents mixed risks and opportunities for the policyowner. Temporary changes in market direction are frozen until the next valuation date, which may work for or against the policy owner.

**Guaranteed Minimum Death Benefit**

Variable life policies must provide that the death benefit shall at all times at least be equal to the initial face amount (the face amount when the policy was issued). The death benefit may increase if investment performance of the side fund is favorable, but can never drop below the guaranteed minimum.

**Conversion (Exchange)**

The conversion or exchange privilege assures variable contract owners that they can transfer to a fixed, guaranteed contract issued by the same insurer if, during the first two years, the owner decides the variable contract was not an
appropriate choice. This usually affords a sense of relief to prospective buyers who may be uncertain if the variable contract is right for them.

The 24-month minimum time period for conversion is set by federal law; each state has the right to establish a longer minimum period.

**THE SEPARATE ACCOUNT: VARIABLE CONTRACT VALUES**

An insurer must establish a separate account for its variable products. Premiums paid for variable life insurance must be placed in the insurer's separate account, which consists primarily of common stocks and other securities-based investments. This portfolio is subject to considerable investment risk.

The return is directly related to the performance of the assets underlying the separate account. Separate accounts are not insured by the insurer and the returns on their investments are not guaranteed. These accounts, and the funds within them, are separate from the company's general account.

To the insurer, this presents a means of transferring the investment risk from itself to the policyowner. The insurer can offer policyowners the possibility (though not the guarantee) of competitively high returns.

**Shelter from Creditors**

Shelter from the insurer's general creditors is another attractive feature of separate accounts. Because they are separate from the company's general account, separate accounts are protected from the claims of the insurer's general creditors.

Policy owners cannot lose the physical assets underlying their life insurance cash values in the event of company insolvency.

The single greatest reason for the variable contract's popularity is the investment control and opportunity for gains that may far exceed the conservative returns guaranteed in fixed contracts. Whereas an insurer may be capable of crediting a currently guaranteed rate of interest through its general account, a separate account investment may realize returns twice that or more.

**Buying Separate Account Units**

Contract owners usually select the separate accounts where they want their policy values invested, depending on their objectives. Most contracts permit contract owners to transfer funds between separate accounts, often at no charge, after the contract has been issued.

Each variable contract premium purchases "units" that represent an undivided interest in the separate account assets. A unit's value is equal to the value of all securities in the separate account divided by the outstanding units. The number of units purchased equals the premium payment divided by the unit value on that day. A variable contract's value at any time is equal to the total units owned multiplied by the unit value at the close of the business day of the valuation.

In cases where a policy's cash value is distributed among several subaccounts, the full contract value is determined by adding together the values of the different subaccounts.

**Separate Account Performance and the Variable Death Benefit**

The advantages and disadvantages of variable life insurance are both related to its investment feature. On one hand, it may perform well and provide higher death benefits than whole life insurance and better returns on investment. On the other hand, it may perform poorly -- and there is greater risk and no guarantees.

The death benefit payable under a variable life policy is determined in the same way as that of a conventional policy. The policy's cash value (generally increasing) plus the insurer's net amount at risk (usually decreasing) equals the death benefit.

With conventional contracts these two aspects of the policy are calculated (and guaranteed) to always equal a certain amount (the face amount), which remains level for the life of the policy.

As with conventional whole life, variable life insurance guarantees the policy's death benefit to be no less than the face amount at policy issue. But with variable life there's the possibility of realizing a death benefit larger than what is guaranteed.
The variable death benefit is directly related to the performance of the contract's separate account. If the separate account growth exceeds the policy's Assumed Interest Rate (AIR), the result is a higher death benefit.

Each year that the actual return exceeds the AIR, there is a positive net investment return, and the death benefit is increased. In years where the actual growth is less than the AIR, the effect is to decrease the death benefit from any previously attained levels. The death benefit however, will never drop below the face amount guaranteed at policy issue.

**Separate Account Performance and the Cash Value**

The cash value, with its direct relation to the separate account, also fluctuates in value daily. However, most contracts stipulate that a variable life policy's cash value will be recalculated once per month. Between these monthly recalculations the cash value amount remains set at the prior month's level.

**Death Benefit Redetermination**

The possibility of increasing death benefits is another popular feature of variable life insurance. The death benefit will be determined on the basis of the separate account value on the contract's valuation date. Changes in the policy's face amount must be redetermined at least annually.

**VARIABLE LIFE POLICY LOANS**

Variable life insurance policies allow their owners to access the cash value through a policy loan. Policy loans are an attractive feature of any permanent life policy.

When a policyowner "borrows" from a policy's cash value, the insurer segregates a corresponding portion of the cash value as collateral for the loan. The "collateralized" cash value continues to earn interest, as does the "uncollateralized" portion.

The borrowed amount, like any loan, accrues interest due at a rate greater than what the cash value is earning. The result is, over time, a net decrease in the cash value.

The loaned amounts, however, earn a fixed, guaranteed rate of interest. Cash values that are subject to a loan do not participate in the separate account's investment performance, as do the unloaned policy values.

Some variable life policy designs allow partial withdrawals as well as surrenders and loans. A partial withdrawal is a permanent surrender of a portion of the cash value that has a direct influence on all policy values, including the death benefit. This option is not standard with variable life policies, but it is more common with variable universal life policies.

As with conventional whole life, variable life policy loans can be repaid at any time, in part or in full, but there is no requirement that they must be repaid. Unpaid loan balances accrue at compound interest and will reduce the death benefit. When loans are repaid, the repayment of the principal is reinvested in the separate account, at current unit values.

Variable life insurance policy loans are limited to something less than 100 percent of the total cash value—usually 75 percent (though some insurers permit loans of up to 90 percent of the cash value).

Under most states' laws, policy loans must be made available (a cash value must start to develop) after the policy has been in force for three years. Variable contracts must permit loans of at least 75 percent of the cash value subject to the following:

- Any outstanding loan indebtedness, including accrued interest, will be deducted from the death benefit at death.
- Any outstanding loan indebtedness, including accrued interest, will be deducted from the cash value upon surrender or the election of a nonforfeiture option.
- The policy may stipulate that loans must be greater than a minimum amount.
- Loan amounts will be withdrawn from a separate account, and loan repayments will be deposited into a separate account.

**DESCRIPTION OF BENEFITS**

The cover page of the policy must contain certain paragraphs describing the variable nature of contract values. The differences between conventional whole life and variable life must be highlighted, including the death benefit, cash value, methods of determining benefits and the
guaranteed interest rate credited to funds allocated to the company's "fixed interest" (general) account.

**INVESTMENT OBJECTIVES**

Variable life contracts must include a provision stating that a separate account's investment objective cannot be changed without the approval of the state Insurance Commissioner.
VARIABLE UNIVERSAL LIFE

This product blends a combination of the variable and universal life insurance concepts. The policy has elements of variable life insurance because it is backed by equity investments. The policy has elements of universal life insurance because it allows the policyowner to adjust the amount of the death benefit and/or the premium.

Variable Universal Life (VUL) is similar to universal life insurance with two major exceptions. First, the cash values are not guaranteed, and there is no minimum interest rate guarantee. The cash value of the policy is determined by the investment experience of a separate account maintained by the insurer. The second major difference is that the cash value is held in a separate account, and VUL policy owners may choose to invest their policies' cash value in any of a variety of separate or subaccounts.

GUARANTEED DEATH BENEFIT RIDER

Some VUL insurers offer a death benefit guarantee, either through an optional rider or as a built-in contract provision. The guarantee protects against poor investment performance only; under funded policies are not protected under the guaranteed death benefit.

DEATH BENEFIT AMOUNT DEPENDS ON DEATH BENEFIT OPTION

VUL offers the same two death benefit options described earlier in Universal Life Insurance. If Option A (decreasing pure insurance protection) is elected, the death benefit remains level as long as the minimum guideline premium is paid and investment returns match assumptions made at policy issue. With Option B, the death benefit rises from the outset and is always equal to the level pure insurance protection plus the policy's account value. If the policyowner wants a death benefit that varies-up and down-with the performance of the contract's underlying investments, he or she should select Option B.

### Comparison of Traditional Life Insurance Forms and Variable Life Insurance

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INDUSTRIAL LIFE & CREDIT INSURANCE

INDUSTRIAL LIFE INSURANCE

Industrial life insurance is characterized by the following features:

- Relatively small amounts of coverage (a few thousand dollars or less)
- Frequent premium payments (monthly or weekly)
- Personal collection of premiums by the agent or a company representative
- Coverage may be available for family members (from birth to age 65 or 70)
- Medical exams are not required
- Grace period of four weeks (28 days) if premiums are paid weekly; 33 days if paid monthly

This form of insurance grew out of the Industrial Revolution and was originally sold to factory workers. Benefits were used primarily to pay for a last illness and burial expenses. Today, this type of insurance is not very practical, due to the very small amounts of coverage involved and the fact it is not economical for agents to personally collect small premiums.

In many states, the maximum aggregate amount of industrial life insurance that can be sold to an individual by an agent is $10,000.

HOME SERVICE LIFE INSURANCE

A variation of industrial life is known as home service life insurance. Policies are usually modest in size, ranging from $10,000 to $15,000 in face value, and are typically sold on a monthly debit plan (automatic bank draft) or payments by mail, which eliminates the need for an agent to collect the premiums.

CREDIT LIFE INSURANCE

Credit life insurance is designed to insure the lives of debtors for the benefit of a creditor (who is the policyowner). In the event that the insured debtor dies, it pays the outstanding balance of the loan.

Credit life insurance may be written on an individual or group basis. It is usually written as decreasing term insurance in connection with a purchase being financed. The total premium is often added to the installment loan payments so that the insurance premium is being financed along with the item being purchased. Insureds are given a certificate of coverage. Coverage terminates if debt is paid off, transferred, refinanced, or becomes significantly overdue.

ENDOWMENTS

Endowments can generally be perceived as forced savings plans with a death benefit. Endowments pay the face amount of insurance to the designated beneficiary if the insured dies within a certain period. If the insured survives to the end of the period, the face amount is paid to the policyowner. From the IRS’s viewpoint, endowments are not considered life insurance.

Endowment insurance is seldom sold today because most endowment policies cannot meet the tax definition of life insurance. Adverse tax consequences have discouraged the sale of new endowment policies. However, many older endowment policies are still in force, and endowment contracts are sometimes used in retirement plans.

An endowment policy has the same structure and all of the same features as a whole life policy; the only difference is an earlier maturity date. An endowment contract has a level face value, level premiums, a declining amount of insurance protection and an increasing cash value which equals the face value on the maturity date. Endowments are purchased for various periods of time, such as 10 or 20 years, or until age 65.

Because endowment policies mature at an earlier age than whole life policies, they have an accelerated rate of cash value accumulation, and the premiums for an endowment policy must be considerably higher than premiums for a whole life policy. An endowment policy will have higher cash and loan values throughout most of the policy period in comparison to a similar amount of whole life insurance.

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TYPES OF ENDOWMENTS

Endowments can be used for different purposes. Retirement endowment contracts are usually sold specifically to provide retirement income, and are designed to mature at age 65 or some other planned retirement date.

A pure endowment contract pays the face amount only if the policyowner lives to the maturity date. It offers no life insurance protection, and pays nothing if death occurs prior to the maturity date. This contract is hardly ever sold because it is basically a savings plan with a risk of forfeiture of the savings.

A more common variation is the juvenile endowment policy, which is designed to mature when a young person reaches a specific age, such as age 18. It is frequently used to build funds for a college education. The contract may be written on the life of the child or on the life of an adult policyholder, usually a parent. It is often more practical to insure the life of the parent, because whether the parent lives or dies, the funds would be available for education.

Endowment insurance policies pay a sum or income to the insured if they live to a certain age. If they die before the specified age, the death benefit is paid to the person named as their beneficiary.

An endowment at age 65 has premiums that are higher than whole life to age 95 due to the shortened length of time in which to accumulate the face amount in the savings portion. Premiums for endowment policies are paid from inception of the policy to the age of endowment or death, whichever occurs first.

An endowment at age 65 whole life policy pays death benefits as any other policy, but pays full face value to the insured if he survives to age 65.

A "twenty pay endowment at 85" combines the limited pay feature with the endowment feature at an age that meets the needs of the insured. This example is illustrated below (E):

Endowment policies can be written to mature in either a certain number of years or at a certain age. Many policies are purchased on the basis of settlement levels -- certain amount of income per month after age 65 -- or on the basis of an amount that can be purchased with an even dollar premium monthly. In addition, some policies pay dividends that add to the savings portion of the policy.

ADVANTAGES OF ENDOWMENTS

The primary advantage of an endowment policy is the forced savings element combined with the life insurance benefit. Unlike voluntary contributions to a savings account, the premiums must be paid to keep the policy in force. This creates a strong incentive to systematically save money. The savings plan is backed up with life insurance protection against premature death.

DISADVANTAGES OF ENDOWMENTS

The forced savings element is also the principal disadvantage of an endowment. Endowments should not be purchased if the person's primary need is for life insurance protection. An endowment policy would provide the least amount of protection per premium dollar. Endowment policies have higher premiums than any other form of life insurance. Since they don't meet
the IRS definition of “life insurance,” the policy owner does not enjoy most of the tax benefits of life insurance.

LIFE INSURANCE POLICY PROVISIONS

Life insurance policies contain a number of important contractual provisions, including the incontestable clause, suicide clause, grace period, reinstatement clause, misstatement of age or sex provision, beneficiary designations, and assignment clause.

Many life insurance policy provisions have become standardized by law, custom, legal challenges, and a desire within the industry for consistency and clarity. Variations do occur, but typical provisions in use today are similar from one contract to another and from one company to another.

Most states have established minimum standards which are based on model laws which require that certain provisions be included in individual life insurance policies, prescribe language for some provisions, and prohibit the use of specific provisions. Generally, an insurer may use alternative provisions, provided that the terms are at least as favorable for insureds and beneficiaries.

The insurance companies also have an interest in using standard contract provisions. Most of the common provisions in use today have been tried and tested in courts of law and, when necessary, modified to clarify intent and reduce confusion or disputes that might arise in the future.

Important policy provisions establish the general agreement between the insurance company and the policy owner. These specify the rights of the parties and the procedures that govern premium payments, grace periods, default and reinstatement of the policy, and transfers and assignments of the incidence of ownership.

INSURING CLAUSE

The insuring clause usually states that, subject to all other terms and conditions of the policy, the company agrees to pay the face amount to the named beneficiary upon due proof of death of the insured, or to pay certain benefits if the insured lives to some specified age, such as 65. It sets forth the basic agreement between the company and the policy holder.

CONSIDERATION CLAUSE

This part of the insuring clause states that the company promises to pay the policy benefits in consideration of the premium payments. An insurance policy is a legal contract. One of the requirements for formation of a contract is that each party give up something of value (consideration). The consideration given by the policyholder is payment of the premiums. The consideration given by the insurance company is the promise to pay policy benefits.

PREMIUM CLAUSE

This provision specifies when, where, and how premiums are to be paid. Usually premiums are to be paid in advance either at the company's home office or to the agent. The various modes of paying the premium will also be identified, such as monthly, quarterly, semiannually and annually.

The least expensive ways to pay the premium are annual payments or monthly bank plan payments. The other premium modes usually require the payment of a service charge added to the basic premium. Service charges are frequently waived for monthly bank plan payments because this is a very reliable method of providing for timely payments. The insurer simply sends a monthly premium notice to the policyowner's bank and the bank sends the insurer a check for the monthly premium.

The actual payment date for premiums and the frequency of the payments are listed on the declarations page of the policy. Changes to payment schedules are allowed. After the policy is issued, paying the premium is the only responsibility of the insured or owner.

GRACE PERIOD

The insured has a grace period of 30 or 31 days from the premium due date in which to make a premium payment.

The purpose of the grace period is to protect the policyholder against an unintentional lapse of the policy. Universal life policies usually have a longer
grace period, such as sixty-one days. During the grace period coverage continues in force. If death occurs during the grace period, the overdue premium is deducted from the death benefits.

**DEFAULT AND LAPSE OF POLICY**

If a premium is not paid before the end of any grace period, the policy will terminate or lapse as of the premium due date, unless coverage was continued as extended term insurance or paid-up insurance under nonforfeiture options.

**REINSTATEMENT**

A reinstatement clause gives the policyowner the right to reinstate a lapsed life insurance policy if certain requirements are met.

- The lapsed policy must be reinstated within five years.
- All unpaid premiums plus interest must be paid.
- The policy must not be surrendered for its cash value.
- All policy loans must be repaid or reinstated.
- Evidence of insurability may be required. However, evidence of insurability is often waived if the policy is reinstated within thirty-one days after the grace period ends.

Usually, the reinstatement process requires submission of a reinstatement request or application, evidence of continued insurability, payment of all overdue premiums (plus interest), and repayment of any outstanding loans or other indebtedness against the policy.

If the policy has not been in force for very long, it may be better to simply purchase a new policy rather than pay back premiums plus interest to reinstate the lapsed policy. However, there are several reasons for considering reinstatement if the lapsed policy had been in effect for a number of years, including:

- The lapsed policy may have more liberal policy provisions
- The lapsed policy may offer lower interest rates on policy loans
- The suicide and incontestable clauses probably no longer apply

- The lapsed policy probably has a much lower premium rate than a new policy would.

**PREMIUM REFUND AT DEATH**

This provision states that any portion of a premium payment, which applies for a period beyond the month in which the insured died shall be refunded as part of the policy proceeds. Since premiums are paid in advance, the insurance company has no right to keep premiums paid for any months of coverage after the insured's death.

**OWNERSHIP RIGHTS**

When a life insurance policy is issued, a number of parties may be involved with respect to contract obligations and benefits. The insurance company is a party to the contract - in exchange for the premium payment, it has agreed to pay certain benefits if the insured dies.

There are 3 additional parties involved:

- The insured is the person whose life is insured. A death benefit will be paid if this person dies while the insurance is in effect.
- The owner of a policy is the person who applies for the insurance, agrees to pay the premiums, and has certain ownership rights. It is the policy owner who has the right to change the beneficiary, to elect settlement options, and to assign ownership to another person.
- A beneficiary is someone who is entitled to death benefits if the insured person dies. There may be one or more designated beneficiaries. There may be primary beneficiaries who are entitled to the proceeds if they are living, and contingent beneficiaries who are entitled to the proceeds if there is no surviving primary beneficiary when an insured dies.

The owner of a policy may or may not be the insured person, and may or may not be the beneficiary. The same person cannot be both the insured and the beneficiary, but the insured's estate may be the beneficiary.
The owner of a life insurance policy is entitled to certain valuable rights, including the right to assign or transfer the policy, and the right to select and change the payment schedule, beneficiary and settlement option. Depending upon the type of insurance, the owner may also have the right to receive dividends, to receive cash values, and to borrow against cash values.

The incidence of ownership in a life insurance policy may affect the taxation of the proceeds. Life insurance proceeds are generally not subject to federal income taxes, but they are included in the deceased's gross estate for federal estate tax purposes if the insured was the owner of the policy at the time of their death, or if the benefits are payable to the insured's estate. However, if the insured is not the owner and the benefits are payable directly to a named beneficiary, the proceeds may be received tax free.

INSURABLE INTEREST

People are not permitted to purchase life insurance on the lives of just anybody. In order to purchase life insurance, a person must have a legitimate insurable interest in the subject of the insurance. There must be a personal risk of emotional or financial loss, and a legitimate interest in preserving and protecting the life being insured. Without a requirement for insurable interest a person might actually act to cause another person's death or fail to exercise reasonable safety precautions to protect someone else if they had no personal risk of loss and stood to gain financially from the death.

Every person is presumed to have an insurable interest in his or her own life. However, if the amount of insurance applied for is disproportionate to a person's apparent needs, it will raise underwriting concerns.

An individual also has an insurable interest in the lives of close relatives through blood or marriage. Usually this extends to those who could be considered "immediate family members," such as a spouse, children, parents, and perhaps brothers and sisters. The requirement for insurable interest becomes more difficult to justify when insuring the lives of more distant relatives, such as uncles, aunts, nephews, nieces, and cousins.

Insurable interest may also be established on the basis of business and financial relationships. Members of a partnership have an insurable interest in the lives of other partners. Lenders have an insurable interest in the lives of borrowers to the extent of the loan. Any commercial enterprise may have insurable interests in the lives of key employees and other individuals who make significant contributions to sales and profits.

In the life insurance business, insurable interest must exist at the time of application and inception of the policy and not necessarily at the time of death. If the insurable interest is valid when it is issued, the death benefit is payable even if insurable interest no longer exists at the time of the insured's death. The requirement for insurable interest applies only to the owner of a policy. Insurable interest is not required of a beneficiary.

TRANSFER OR ASSIGNMENT OF OWNERSHIP

Ownership of a policy may be transferred or assigned to the insured, to the insured's new spouse, to children, or to someone else who has a more current insurable relationship with the insured, or even to a charity or other business organization.

The owner of a policy has the right to transfer or assign all or any portion of the rights of ownership to another person. Usually this is accomplished by written request. When the request is received by the insurance company, the change takes effect as of the date it was signed by the owner regardless of whether the owner is still living at that time. However, the company is not liable for any action taken before the request is received.

The interests of a life insurance policy may be assigned to anyone, even those without an insurable interest in the life of the insured. The assignment clause specifies the procedures for notifying the life company of the assignment. There are two types of assignments of life insurance contracts:

- An absolute assignment gives the assignee every right in the policy that the owner possessed before the assignment. All "incidents of ownership" are transferred. An absolute assignment is a permanent and complete assignment of a policy's ownership rights and privileges.
- A collateral assignment is a more limited type of assignment that only transfers some of the "incidents of ownership" to the assignee for a limited period of time. A
collateral assignment is a temporary and partial assignment of the ownership rights.

A collateral assignment might be used to provide security (collateral) to a lender if the policyholder borrowed some money. If a collateral assignment is made, as security for repayment of the loan, the lender receives only those rights necessary to provide security for the loan. The owner would retain other rights (such as the right to designate or change a beneficiary), but could not cash in the policy or exercise any ownership right that would impair the security arrangement of the collateral assignment.

POLICY LOAN PROVISIONS

Policy loan provisions are found in all policies that include cash values. By law, after a policy has been in force for a specified period of time (usually three years), it must contain some cash value which may be borrowed by the policyowner.

Generally, a policyowner may borrow up to the amount of the current cash value less any indebtedness against the policy (previous loans and interest charges). The insurance company will charge interest on policy loans. The amount of interest is usually relatively nominal and regulated by state laws. If the loan amount and interest due are not repaid, these amounts will be considered indebtedness against the policy and will be deducted from the death benefit should the insured die while the indebtedness is outstanding.

The reason that the face value (death benefit) must be reduced by any outstanding loans, and that any outstanding indebtedness (loans plus interest) must be repaid to fully restore policy values, is that the contract values all depend upon the required premium payments being made when due, and upon the schedule of cash value accumulation and the interest rate stated in the policy. While a loan is outstanding, part of the cash value is no longer being held by the insurance company and is no longer earning interest for the client.

Also, remember that the death benefit consists of the pure protection plus the cash value. Since the loan has reduced the cash value, it has also reduced the death benefits payable. If a loan is not repaid, the remaining cash surrender value and the face value must be reduced.

An insurer may defer a loan request for up to six months from the date of the loan application, unless the reason for the loan is to pay premiums due. If the automatic premium loan provision is added (at no cost) to a cash value policy, an overdue premium is automatically borrowed from the cash value at the expiration of the grace period. This provision prevents the policy from lapsing because an overdue premium has not been paid.

INCONTESTABILITY

The incontestable clause has great value for the insured. Under this clause, the insurance company agrees not to use any error, concealment, misstatement, or even fraud on the part of the policyowner, as a defense against a claim after the policy has been in effect for a certain length of time, usually two years. After that time, the policy coverage may not be challenged except for nonpayment of premiums.

The purpose of the incontestable clause is to protect the beneficiary if the insurer attempts to deny payment of the death benefit several years after the policy is issued. Since the insured is dead, the insurer’s allegations concerning statements in the application cannot be easily refuted. After the contestable period has expired, the insurer must pay the death benefit.

The initial period of time during which the contract may be challenged should provide the insurer with a reasonable opportunity to discover any material misrepresentations through background checks, medical exams, and other sources of underwriting information.

ENTIRE CONTRACT AND REPRESENTATIONS

The policy, together with the application attached, constitutes the entire contract. This provision limits the use of evidence other than the contract and the attached application to challenge the contract’s validity. All statements made by the insured in the application are deemed to be representations, and not warranties.

The distinction between warranties and representations is significant. Under a strict interpretation, any breach of warranty (whether or not material) would provide grounds for voiding the insurance. In the case of representations, the
validity of a policy may be challenged by the insurance company only on the basis of a material misrepresentation made in the application.

The entire contract provision also specifies that an insurance agent cannot alter or change the policy. Only company officers have the authority to change or amend the insurance contract, and any such changes or modifications must be in written and be attached to the policy.

**POLICY DATES**

Policy years, policy months, and policy anniversaries are measured from the policy date. As some of the provisions in a life insurance policy are limited or dependent on the passage of time, this provision is important. The suicide and incontestable clauses are also measured from the policy date. Some states allow "back dating" a policy. Backdating establishes an earlier policy date, may grant the insured a lower premium because of an age change.

**MODIFICATION OF POLICY**

This clause specifies that only certain officers of the insurance company have the authority to change or modify the insurance contract. All changes or modifications to the policy must be made in writing, and must be attached as an endorsement or rider. Life insurance riders will contain the required signature of a company officer (such as a vice president or secretary). When an endorsement or rider is issued by the company and attached to the policy, it becomes part of the legal contract. No agent has the authority to change a policy or to obligate (bind) the insurance company in any way by making a promise which is not contained in the policy.

**POLICY CHANGE (CONVERSION OPTION)**

Some policies may contain a provision which permits the policyowner to exchange the policy for another type of policy currently being issued by the company. This exchange is usually made from one policy type to another policy form with the same face amount.

When a change is made to a policy with a higher premium (such as when term insurance is converted to whole life), then the insured merely has to pay the higher premium and no proof of insurability would be required. However, if the exchange results in a lower premium, proof of insurability may be required since this could result in adverse selection against the insurer.

**MISSTATEMENT OF AGE OR SEX**

The misstatement of age or sex provision states that if the insured's age or sex is misstated in the application, the amount of death benefit payable is the amount that the premiums paid would have purchased at the correct age and sex. The adjustment in the policy benefit may be upward or downward depending on whether the insured was younger or older than the misstated age.

These adjustments are not limited to claims for death benefits. If a misstatement of age or sex is discovered while an insured is alive, the policy will be adjusted accordingly. This may affect the face value of the policy, cash values, and other policy values. This is not limited by the incontestability period.

**FREE LOOK**

In most states a policy of individual life insurance must contain a free look provision. This is a notice stating that the policyholder has a period of time (usually 10 days to 30 days) from the date the policy is delivered to review it and return it for cancellation and receive a full refund of premium if not satisfied for any reason. This provision gives the policyholder a reasonable opportunity to review the entire contract and reevaluate the decision to purchase.

**MEDICAL EXAMINATIONS AND AUTOPSY**

Some states require life insurance policies to include a provision that gives the insurance company the right and opportunity, at its own expense, to conduct a medical examination of the insured as often as reasonably required when a claim is pending, and to make an autopsy in case of death where it is not forbidden by law.
**BENEFICIARY PROVISIONS**

Since all life insurance policies pay a death benefit, each policy will include some kind of beneficiary provision.

The beneficiary is the person or party named in the policy to receive the policy proceeds. There are numerous Beneficiary Designations in life insurance such as:

A beneficiary is the person or interest to whom payment of the life insurance proceeds will be made upon the death of the insured. The owner of a policy has the right to direct the payment of proceeds to any person or entity he or she chooses. A variety of different parties or interests may be designated as beneficiaries under a life insurance policy. The beneficiary may be a person or an institution, such as a foundation or charity. A specifically designated person, more than one person, or a class or classes of persons may be named as beneficiaries; in addition a policyowner may name his or her estate, an institution, a corporation, a trust, or any other legal entity as a beneficiary.

Beneficiary selection is first made in the application for the life insurance. The beneficiary designation clause in the policy establishes how a beneficiary may be changed.

The beneficiary provision itself may be very brief. Generally, it states that upon the death of the insured, the policy proceeds will be paid to one or more designated beneficiaries. The choice elected in the application will stay in effect unless changed by the policyowner. It is important to keep beneficiary designations up-to-date as situations change. It is also important to understand the rights associated with a beneficiary designation, and how the type of designation made may affect the payment of life insurance proceeds.

If no beneficiary is living or chosen upon the death of the insured, proceeds will be paid to the owner or the owner's estate. Some policies may include more detailed provisions concerning payments to a succession of beneficiaries, payment of proceeds in the absence of a beneficiary, and procedures for changing a beneficiary designation. There are different types of beneficiary designations.

**Revocable vs. Irrevocable**

A revocable beneficiary designation is one that may be changed at any time by the policy owner. Almost all life insurance beneficiary designations are revocable unless the policyowner has specifically given up the right to change the beneficiary.

An irrevocable beneficiary designation is one that cannot be changed without the consent of the beneficiary. When an irrevocable designation is made, the owner has given up the future right to change designations. In the event that an irrevocable beneficiary dies before the insured, the right to select the beneficiary often reverts back to the policyowner.

**Methods of Designating Beneficiaries**

There are two methods for naming and changing life insurance beneficiaries - the filing method and the endorsement method. Under the filing or recording method the request must be "filed" in writing with the insurer. The request is made effective by the insurance company "recording" the change in its records. Once recorded, the change takes effect as of the date the policyowner signed the request.

Under the endorsement method the beneficiary designation or change is on or affixed directly to the policy. The policyowner must make a written request and mail the request along with the policy to the insurance company. The insurance company will then make sure that the beneficiary change is made to the policy.

**Succession of Beneficiaries**

A policy may provide for multiple beneficiaries as well as a succession of potential beneficiaries. Types of beneficiaries that can be designated in life insurance policies include the following:

- The primary beneficiary is the first party entitled to receive the death benefit at the insured's death. If there is more than one primary beneficiary, they may share equally or according to some predetermined arrangement.
- The contingent (or secondary) beneficiary is the beneficiary who is entitled to receive
the death benefit if there is no surviving primary beneficiary.

- A tertiary beneficiary occupies the third level of succession of beneficiaries and would be entitled to receive the proceeds only if all primary and contingent beneficiaries have died before the insured.

**Per Capita**

Under a per capita designation, which means "by heads," each surviving class member shares equally in the death benefit. If any class member predeceases the insured, that portion of the proceeds is forfeited to the remaining class members, who receive a greater share. No benefits are preserved for any descendants of a deceased beneficiary.

**Per Stirpes**

Under a per stirpes designation, which means "by stock" or family line, the portion of proceeds intended for each class member is preserved for their descendants, if any. Each child, grandchild, or great grandchild of a beneficiary moves up in place of a deceased beneficiary. If any class member predeceases the insured, that portion passes to any children or grandchildren, and the other class members would not get a greater share.

**Beneficiaries Must Be Clearly Named**

It is important to clearly name intended beneficiaries and to clearly state intent, because careless wording of beneficiary designations can result in undesirable consequences. When the intention is not clear, the insurer must distribute the funds according to the apparent intent of the insured, or ask the court for a judicial determination of the proper distribution. Intended beneficiaries may end up without a share of the proceeds, and heirs may end up fighting in court.

- A specific beneficiary designation means that the beneficiary is named and can be clearly identified, such as "First Name, Last Name, son of the insured."
- A class beneficiary designation means that a specific individual is not identified but is a member of a group to whom the proceeds are paid, such as "children of the insured."

Designating a "husband" or "wife" (not specifically named), might cause a problem if that person was married more than once. Designating current children by name, might not provide for unborn or adopted children.

**Designation Options**

- The **Primary** Beneficiary is the first party who is entitled to receive the proceeds at the insured's death.
- The **Contingent** Beneficiary is the beneficiary entitled to proceeds if the primary beneficiary is not alive.
- A **Revocable** Beneficiary designation means that the policyowner has the right to
change the Beneficiary Designation without the beneficiary's consent.

- **An Irrevocable** Beneficiary designation means that the policyowner cannot change the beneficiary without the irrevocable beneficiary's consent.
- **A Specific** Beneficiary designation means that the beneficiary is named and can be identified. For example, Martha Smith may be specifically named to receive the policy proceeds if her husband should die.
- **A Class** Beneficiary designation means that a specific individual is not named but is a member of a group to whom the proceeds are paid. One example of a class Beneficiary Designation would be "children of the insured."

An individual may designate a wide variety of beneficiaries. Many people are primarily concerned with providing for a surviving spouse and children. A very wealthy individual might also wish to allocate funds to various charities, trusts, and non-relatives. Designation options may include any combination of the following:

- Individuals
- Minors (guardian required to receive funds for minor)
- Classes of individuals
- Trusts (funds to be administered according to trust agreement)
- The insured's estate

**Minor Child**

When a minor named as beneficiary, it is necessary for a guardian to be appointed to receive the funds on behalf of the minor. Insurance companies usually will not pay proceeds directly to a minor, since the minor cannot give a valid release for receipt of the funds.

Some parents anticipate this problem by establishing a trust to administer the life insurance proceeds and all other property in the estate of the parents in the event that both parents die leaving minor children.

**Class Designations**

Class designations should be used when individuals of a specific group (such as children of an insured) are to share the policy proceeds equally and when the composition of that group might change.

The wording of a class designation, just as the wording of an individual designation, must be chosen carefully to specify the insured's actual intentions. Different approaches may be taken to class designations.

**A Trust**

A trust is formed when the owner of property (the grantor) gives legal title of that property to another (the trustee) to be used for the benefit of a third individual (the trust beneficiary). A trust may be established either during the grantor's life or after the grantor's death. An inter vivos trust is one that takes effect during the lifetime of the grantor. A testamentary trust is one created after the grantor's death, according to the provisions of the grantor's will.

When a trust is named as beneficiary, upon the death of the insured, the proceeds would be paid to the trust and the trustee would then administer the funds in accordance with instructions in the trust agreement.

**Insured's Estate**

An insured's estate may be named as the beneficiary. The insured may direct that the policy proceeds be payable to his or her executors, administrators or assignees. Such a designation might be made by in order to provide funds to pay estate taxes, expenses of past illness, funeral expenses, and any other debts outstanding prior to the settlement of the estate. Designating the insured's estate as beneficiary may aid in the settlement of the estate by avoiding the need to sell other assets of the estate to pay these last expenses.

It is usually not desirable however, to name the estate as beneficiary because the insurance proceeds then become assets of the estate and are subject to the claim's of creditors. In addition, these proceeds will increase the size of the estate as well as the expenses, inheritance taxes, and federal estate taxes involved in estate administration and settlement.
**The Uniform Simultaneous Death Act**

A problem often arises when an insured and the primary beneficiary die simultaneously with no evidence as to who died first. Many states have adopted the Uniform Simultaneous Death Law. Under it, if there is no evidence as to who died first, the policy will be settled as though the insured survived the beneficiary. The life insurance proceeds would be paid to any contingent beneficiaries or to the estate of the insured - not to the estate of the beneficiary. If there is clear evidence that the beneficiary survived the insured, however, then the proceeds are payable to the beneficiary's estate.

**Common Disaster Clause**

Many policies include a common disaster provision to address the problems that could arise when an insured and beneficiary die at virtually the same time, or when the beneficiary dies a short time after the insured.

This provision stipulates that the primary beneficiary must survive the insured by a specified period of time, such as 30, 60 or 90 days, in order to receive the proceeds. When such a provision is in effect and the primary beneficiary survives the insured by only a few hours or a few days, the proceeds would be paid directly to any contingent beneficiaries or to the insured's estate.

**Facility of Payment Provision**

Typically, this provision is found in policies with relatively small death benefits. It permits the insurance company to facilitate the payment of death proceeds by selecting a beneficiary if no beneficiary has been named or if a named beneficiary cannot be found after a reasonable time. Usually the insurer will select someone who is in the deceased insured's immediate family (such as a spouse, parent, brother, sister, etc.) or someone who has incurred expenses for the insured's last illness or funeral.
EXCLUSIONS & LIMITATIONS

While life insurance policies generally have few exclusions, each contract is likely to include some limitations. The most common exclusions relate to:

- Aviation exposures
- Hazardous occupations
- Suicide
- War risks

AVIATION RESTRICTIONS

When aviation exclusions are found in life insurance policies they usually apply only to pilots, student pilots, and crew members, or to occupants of military aircraft - these restrictions do not apply to fare-paying passengers on regularly scheduled airlines. Companies will often provide coverage for civil aviation deaths for an additional premium charge.

HAZARDOUS OCCUPATIONS AND AVOCATIONS

Today few applicants are declined life insurance because of their occupations. Firefighters and police personnel can purchase life insurance at standard rates. Even commercial airline pilots can usually purchase life insurance (although possibly at higher than standard rates). As a result, occupational exclusions are rarely found in modern life insurance policies.

An underwriter today is more likely to be concerned with hazardous avocations or hobbies. If an applicant participates in a hazardous hobby such as auto racing or sky diving, then the amount of insurance available may be limited, or an extra premium may be charged due to the additional risk. Depending on the hobby, the underwriter may want to include a waiver which excludes payment of the death benefit if death is caused as a result of participation in a particularly hazardous activity.

SUICIDE

A suicide clause in a life insurance policy states that the insurer will not pay the death benefit if the insured commits suicide within a certain period (usually two years) after the policy becomes effective. In some policies, suicide is excluded for only one year. The only payment the beneficiary receives in this case is a refund of the premiums paid less any policy loans. The suicide clause provides the insurer with some protection against an insured who purchases a life insurance policy with the intention of committing suicide.

After the policy is in effect for two years, suicide is covered since it is not likely that anyone who intends to commit suicide would buy life insurance and then wait two years to do it.

WAR AND MILITARY SERVICE

Today, most insurers will provide some form of life insurance coverage for those on military duty. During war, war-related death exclusions may be attached to new policies of insureds of military age. Traditionally, there are usually two types of restrictions or clauses which may be used.

- A status clause may limit the amount of insurance that a person is available for while on active military duty, or it may impose a higher premium to cover the higher risk involved.
- A results clause may exclude payment of the death benefit if the insured is killed as result of an act of war.

In cases where a war or military restriction applies to a death claim, the insurance companies will often refund the premiums paid (plus interest), or pay an amount equal to the policy's cash value, if greater.

PROHIBITED PROVISIONS

By law in most states, life insurance policies are not permitted to contain the following provisions:

- A provision that limits the time for bringing any lawsuit against the insurance company to less than one year after the reason for the lawsuit occurs
- A provision that allows a settlement at maturity of less than the face amount plus any dividend additions, minus any outstanding indebtedness and overdue premiums
- A provision that allows forfeiture of the policy because of the failure to repay any policy loan (or interest on the loan) if the
total owed is less than the loan value of the policy

- A provision making the soliciting agent the agent of the person insured under the policy or making the acts or representations of the agent binding on the insured (under the law, an agent represents only the insurance company, not the insured)
LIFE INSURANCE POLICY OPTIONS

Life insurance contracts offer a number of policy options which give insureds and beneficiaries the opportunity to make choices that affect how certain features of the policy will apply. This creates a degree of flexibility in the ways in which life insurance products may be used to meet the specific needs of a particular individual or family.

SETTLEMENT OPTIONS

Settlement options are available under all types of life insurance. Settlement options refer to the various ways that the policy proceeds can be paid other than in a lump sum. The purpose for which the insurance was originally purchased and the situation at the time the benefits are to be received often dictate the most appropriate method of settlement.

ELECTING AN OPTION

The policy owner can elect a settlement option before the insured's death. If the policyowner has not selected a settlement option the Beneficiary has the right to select the method of payment after the death occurs. The purpose of the insurance often dictates the most appropriate mode of settlement.

The same options are available whether the proceeds are being distributed to an insured or at retirement or maturity to a beneficiary at the insured’s death. Generally, the following optional modes of settlement are available:

- Lump sum (default)
- Interest only
- Fixed-period installments
- Fixed-amount installments
- Life income
- Joint and survivor
- Any other method approved by the insurer

In addition, most companies will agree to distribute the proceeds under any reasonable and actuarially sound mode.

Lump Sum (Default Mode)

Life insurance proceeds may be paid as a lump sum. It is the method of settlement when no other method has been elected -- the default mode.

The major types of life insurance policy options include settlement options, nonforfeiture options, and dividend options.

There may be occasions when a lump sum settlement is ideal, such as when the proceeds are intended to pay off a specific obligation, or when a designated beneficiary is highly skilled in handling and managing money. But in many cases, other options may be more appropriate.

Interest Only

Under this form of settlement, the proceeds are held by the insurance company and the interest earned on the proceeds is paid to the beneficiary, at least annually. The rate of interest paid is stated in the policy. The interest option is appropriate when the funds will not be needed until a later date.

This option might also be ideal when there is a need to provide a continuing income for a long period of time and/or when the beneficiary is unable to handle large sums of money, as in the case of minors or elderly persons.

Several conditions may be elected in connected with the interest only option. A policyowner might specify:

- That the proceeds will remain on an interest only basis for a stated period of time, and the remainder paid in cash or under one of the other settlement options; or
- That no part of the principal is ever to be paid to the beneficiary, but will be paid to a contingent beneficiary upon the death of the primary beneficiary; or
- That the beneficiary may withdraw the principal, in whole or in part, or elect another settlement option, at any time

Fixed-Period Installments

Under this option, the proceeds are retained by the insurance company and paid out in equal
installments over a specified period of months or years. The payments are comprised of both principal and interest, and are designed to exhaust the principal at the end of the installment period.

The fixed-period option is appropriate when income is needed over some fixed period, such as income during the readjustment, dependency, or black-out periods.

The advantages of this method of payment are that the payment period is guaranteed, and payments will continue even if the primary beneficiary dies. The disadvantages of this method are that the beneficiary(ies) may outlive the payment period, in which case benefits are exhausted and all payments stop, and the survivors might not have developed alternative sources of income during the transition period. Additionally, the amount of the periodic payments may not provide an adequate income for survivors.

**Fixed-Amount Installments**

In this case, the proceeds are retained by the insurance company and paid out in specified amounts on a fixed, periodic basis (annual, semiannual, quarterly, or monthly). Payments of the predetermined amount are made until the proceeds (principal) and interest are exhausted.

Under this option, benefit payments may also be continued to one or more contingent beneficiaries if the primary beneficiary dies before the proceeds are exhausted. This option might be selected when the primary focus of the perceived need for insurance is on the amount needed by survivors, rather than on the length of time income is needed.

The advantages of this method of payment are that the amount of each payment is guaranteed, and payments will continue even if the primary beneficiary dies. The disadvantages of this method are that the higher the amount of each benefit installment, the more rapidly the principal is exhausted, and the beneficiary(ies) may outlive the payment period before they have developed alternative sources of income.

**Life Income**

Under the life income option, the proceeds are retained by the insurance company and paid out in equal installments (monthly, quarterly, semianually, or annually) as long as the recipient (insured or beneficiary) lives.

The benefit amount is calculated on a basis of the recipient's life expectancy at the time payments begin. Life expectancy figures for men and women at various ages are statistical averages shown in mortality tables. The older the recipient at the beginning of the payment period, the larger the benefit per $1,000 of proceeds.

Actual amounts paid under the life income option may exceed the insurance proceeds (if the person lives a long time) or may only be a portion of the proceeds (if the person dies sooner than expected).

**Life Income with Period Certain**

Adding a period certain to the life income option reduces the size of the income installments. The longer the period certain, the greater the reduction. A period certain increases the chance that payments will be made beyond a recipient's lifetime.

If the initial recipient dies prior to the end of the period certain, payments would continue to be paid to a beneficiary or contingent beneficiary until the end of the period (or the value might be paid to the estate of the last surviving beneficiary).

**Joint and Survivor**

A variation of the life income concept is the joint and survivor settlement option. Under this method, installment payments are guaranteed to be made during the lifetimes of two recipients. When this option is in effect, periodic installments are paid initially to both parties. Upon the death of either one of the recipients, periodic payments continue to be made to the survivor for life.

Electing payments on a joint and survivor basis is the most practical way to provide a guaranteed lifetime income for two people. A joint and survivor option is always a wise recommendation to make when benefits are to be shared by two people.

Under a joint and full survivor option (also known as a "straight joint and survivor" option), the same benefit amount is paid to both recipients while living and to the survivor after one of them dies. Under a joint and one-half survivor option, a higher benefit is paid while both are living and one-half of that amount is paid to the survivor after the other person

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dies. Other variations of this method include the “joint and two-thirds survivor” and “joint and one-quarter survivor” options.

The amount of the installment payments is based on the life expectancies of both recipients. When a reduced benefit is elected for the survivor, the joint benefit paid while both are living will be greater because the insurance company does not have to set as much aside to provide for the survivor benefit.

**Other Methods**

In addition to the traditional methods of settlement which are widely available, most insurance companies will agree to distribute the proceeds under any reasonable and actuarially sound method. Special settlement arrangements are sometimes desirable in order to accomplish the estate planning objectives of an insured, or to provide different degrees of security when multiple beneficiaries are involved. Insurance companies will cooperate with almost any arrangement that is reasonable.

**PAYMENT OF SMALL AMOUNTS**

Insurance companies have rules to avoid arrangements which are uneconomical to administer. A common provision found in the settlement options section of a policy states that if net proceeds of less than $5,000 are payable to any one payee, the proceeds will be paid as a single sum.

Another common provision addresses the problem of minimum installments. If periodic payments based on the number of dollars of benefit per $1,000 of proceeds is less than $50, the payment intervals will be lengthened so that minimum payments of at least $50 will be made.

**TIME LIMITATIONS**

Time limitations may also apply to some settlement options. It is not a good business practice, and might not even be legal, to hold insurance proceeds for an indefinite period of time. Consequently, a company may set a time limit for holding proceeds at interest, such as for the lifetime of the primary beneficiary or the lifetime of a contingent beneficiary.

**WITHDRAWAL PROVISIONS**

This provision is sometimes used in connection with settlement options, especially the “interest only” option. A withdrawal provision gives the beneficiary the right to withdraw a portion of the funds left on deposit with the insurer in the event of certain contingencies or emergencies. The provision may specify that the beneficiary has a right to withdraw only a percentage or a dollar amount of the proceeds.

**OTHER SETTLEMENT OPTIONS**

All life insurers have spendthrift provisions available, which allow the owner of a policy to predetermine the settlement option for a beneficiary. The beneficiary then has little or no chance to change the options. It prevents a beneficiary from exchanging a life income for a lump sum. The theory is that less money is squandered if it is received periodically instead of in a lump sum.

**ADVANTAGES OF SETTLEMENT OPTIONS**

One of the principal advantages for the insured or beneficiary in selecting one of the various settlement options is freedom from investment concerns. If a beneficiary elects a lump sum settlement of the death benefit, then he or she must decide how to use or invest the money. When lump sum settlements are spent recklessly, the funds do not provide any long-term security. By electing a settlement option other than a lump sum, the beneficiary is trusting in the expertise and knowledge of the insurance company to administer these proceeds and provide some form of income over a period of time.

Another advantage to settlement options is the fact that any of the options will guarantee a greater return than taking the full proceeds in a lump sum, since the insurance company pays interest on any funds it retains.

One of the unique features of life insurance is that the life insurance proceeds are exempt from the claims of a deceased insured's creditors as long as there is a named beneficiary other than the insured's estate. A similar provision that protects payments to a beneficiary from claims of the beneficiary’s creditors is known as the spendthrift
clause. It is designed to protect the proceeds from attachment or assignment to others. However, it does not apply to lump sum settlements - it applies only to installment settlement options, and it only protects the portion of the proceeds not yet paid (due, but still held by the insurer) from the claims of creditors. This must be elected by the policyowner during the insured's lifetime.

When in effect, as long as the proceeds are being paid by periodic installments to the beneficiary, both the principal retained by the insurance company and the payments received by the beneficiary are exempt from the claims of creditors and from any other assignment or attachment.

<table>
<thead>
<tr>
<th>A COMPARISON OF SETTLEMENT OPTIONS TO TRUSTS</th>
</tr>
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<tbody>
<tr>
<td>SETTLEMENT OPTIONS</td>
</tr>
<tr>
<td>Discretion</td>
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<tr>
<td>Flexibility</td>
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<tr>
<td>Guarantees</td>
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<td>Return on Investments</td>
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<tr>
<td>Life Income</td>
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<td>Expense</td>
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<tr>
<td>Counseling</td>
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<tr>
<td>Title</td>
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<td>Segregation of Funds</td>
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</table>
NONFORFEITURE OPTIONS

All states have nonforfeiture laws that require insurers to pay at least a minimum nonforfeiture value if a policyowner surrenders a cash value policy. Nonforfeiture provisions protect a policy owner's equity, the accumulated cash value, in a life insurance policy. By law, this equity cannot be lost (forfeited) if the policy is surrendered at any time or if premium payments stop and the policy lapses or terminates. The standard nonforfeiture options include taking the cash value, converting the cash value to extended term insurance, or converting the cash value to reduced paid-up insurance.

TRADITIONAL OPTIONS

Nonforfeiture options in a life insurance policy give the policyowner a choice of ways to use the cash value if the policy is terminated and protect the policyowner from forfeiting the cash value. There are three nonforfeiture options:

- Cash surrender value
- Extended term insurance
- Reduced paid-up insurance

These three options are specified in the guaranteed values or nonforfeiture provisions section of permanent life insurance policies. The extended term option is usually automatic unless the policy owner selects another option.

CASH SURRENDER

The policy can be surrendered for its cash surrender value, and protection under the policy ceases. When this done, the policy terminates and all interest in the policy ceases. This is known as "cashing in" an insurance policy. Cash values are relatively low during the early years but can accumulate to sizable amounts over time.

Surrender charges may be imposed when a policy is cancelled during the early years, to cover the expenses of policy surrender.

EXTENDED TERM INSURANCE

Under this nonforfeiture option, the cash surrender value is used to buy level term insurance in the same face amount as the current policy, for as long as the cash value will pay the new policy premium. Once converted to extended term insurance, no further premium payments are required.

The face amount of the policy would remain as originally issued. If any loans are outstanding, they will reduce the face amount. Similarly, if there are any "dividend additions," they will increase the face amount.

REDUCED PAID-UP INSURANCE

Under this nonforfeiture option, the cash value of the policy is used as a single premium to provide life insurance on the same type of policy as the current policy, for as large an amount as the cash value will purchase at the insured's age when the option becomes effective. The new policy is fully paid-up. The policy owner now has the same type of insurance, for the same period of time, but with a reduced amount of face value.

TABLE OF GUARANTEED VALUES

Nonforfeiture rights are protected by state law. The laws specify the formulas, mortality tables, interest rates and other factors that must be used for determining minimum surrender values and other nonforfeiture benefits. Each policy that includes nonforfeiture benefits includes a table of guaranteed values which shows the guaranteed values at the end of various policy years. Usually, these values are shown annually for each of the first 20 policy years, and for representative years thereafter (such as at age 60 and age 65).

A cash value policy contains a table of nonforfeiture options that shows the value of each option at various attained ages. A sample table of guaranteed values is shown below.

ELECTING AN OPTION

A policy's nonforfeiture provisions begin to apply when a premium payment is in default. The policyowner usually has the right to elect one of the available nonforfeiture options within 90 days after the premium default date. The election is usually required to be in writing. If the policy owner does
not designate a nonforfeiture option, the extended term option will be selected by the company. It gives the insured the same amount of protection for the longest period of time.

**AUTOMATIC PREMIUM LOAN**

The automatic premium loan (APL) option protects a policyowner from an unintentional lapse of the policy. If the APL is selected, at the end of the grace period the insurer automatically borrows enough money from the cash value to keep the policy in full force. None of the nonforfeiture options will be necessary if APL is added to the policy.

<table>
<thead>
<tr>
<th>End of Policy Year</th>
<th>Cash Value</th>
<th>Insurance</th>
<th>Paid-up Insurance Years</th>
<th>Paid-up Insurance Days</th>
<th>End of Policy Year</th>
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<td>$1,025</td>
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<td>343</td>
<td>Age 65</td>
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**DIVIDEND OPTIONS**

Life insurance policies may be issued on either a nonparticipating or participating basis. A participating policy is one that pays dividends. Generally, the premiums for participating policies are higher than for non-participating policies, and dividend payments declared by the insurer are considered to be a return of the excess premiums.

Policy dividends are not guaranteed, but are usually declared as long as the insurance company remains profitable. As a matter of practice, most insurance companies declare and pay dividends annually on participating policies.

The owner of a participating policy is usually offered several options for receiving the policy dividends.

**TRADITIONAL OPTIONS**

Standard dividend options have been developed to satisfy the most common preferences for applying dividends but, as is the case with settlement options, many companies will agree to any other method which is found to be acceptable. Available options may differ somewhat by company. The most commonly offered dividend options include:

- Cash payment
- Application to reduce premium
- Accumulation at interest
- Paid-up additions
- Accelerated endowment
- Paid-up option

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• One-year additional term option
• Any other method approved by the insurer

**Cash Payment**

Under this option, dividends are simply paid to the policyowner in cash as declared by the insurer. The policyowner receives a check from the insurer, usually on the anniversary date of the policy. The dividend is relatively small in the early years but can increase to sizable amounts in later years.

**Premium Reduction**

Under this option, the current dividend is used to reduce the next premium payment. After this option has been elected, the premium notice will usually show the gross premium due minus the dividend amount, and the policyowner merely has to send a check for the net amount.

**Accumulation At Interest**

This means electing to allow dividends to accumulate and be retained by the insurance company, and to earn interest at a rate specified in the policy. This option usually permits the withdrawal of the accumulations at any time. Although dividends are not taxable as income, any interest earned on them is taxable.

**Accelerated Endowment**

Under this option, policy dividends are used to convert the policy into an endowment or, in the case of an existing endowment contract, to shorten the endowment term. In either case, the dividends are allowed to accumulate, and when the combination of dividends and cash value equal the face value, the policy matures at an earlier date.

**Paid-Up Additions**

Under this option policy dividends used to buy additional amounts of paid-up participating insurance, written on the same basis as the underlying policy. These increments (often referred to as “dividend additions" or “paid-up ads") are actually small amounts of additional insurance purchased with a single premium. No new policies are issued; the original policy is simply amended to reflect the additional paid-up values.

When this option is elected at the time of policy application, the additional paid-up insurance is provided without proof of insurability. The company may require proof of insurability if this option is elected several years after the policy is issued.

**One-Year Term Option**

Under this option, dividends are used to buy an additional amount of one-year term insurance. Unlike other "additions," any term insurance additions are not allowed to accumulate. Each term addition will automatically expire at the end of the policy year, so that only one term insurance addition purchased with dividends may be in effect at any one time. If the one-year term insurance option is not selected at the time the policy is issued and it is requested later, evidence of insurability will usually be required to guard against adverse selection.

**Other Methods**

In addition to the traditional dividend options, many insurance companies will agree to apply dividends in any manner which is reasonable and mathematically sound.

The owner of a participating policy is usually offered several options for receiving the policy dividends.

**ELECTING AN OPTION**

Initially, a dividend option is usually selected at the time of application for insurance. Application forms frequently include a place to select one of the standard dividend options when a participating policy is applied for. However, the policy provisions typically permit the policyowner to elect any dividend option within 31 days after the dividend due dates. Dividends are most commonly payable annually and become due on the policy anniversary.

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LIFE INSURANCE POLICY RIDERS

Riders are attachments or endorsements to a life insurance policy which change the contract in some manner. Riders may be used to add benefits to a policy or to take benefits away or impose restrictions. When a rider adds an additional benefit, an additional premium is usually charged. But the addition of a rider has no effect on the cash value of a policy.

Some common riders include the following:

- Multiple Indemnity – Accidental Death
- Accidental Death & Dismemberment
- Waiver of premium
- Guaranteed insurability
- Cost-of-living rider
- Accelerated death benefits

MULTIPLE INDEMNITY (ACCIDENTAL DEATH)

This rider provides an additional death benefit only if the death is accidental. The accidental death benefit is frequently called as double or triple indemnity. Double indemnity pays twice the policy’s face amount, and triple indemnity pays triple the base policy’s face amount if death occurs accidentally.

Multiple indemnity riders are relatively inexpensive because the chance of accidental death is small and accidental deaths are included in mortality tables.

There can be value in the accidental death benefit, but it should not be oversold. There is a tendency among insureds to think that they have more life insurance than they really have because of the endorsement. The life insurance policy to which the rider is attached is the most that most people will receive. The human life value or the needs do not change if the insured dies in an accident rather than by natural causes. Premium dollars spent on accidental death insurance might be more wisely used on additional life insurance.

Death from disease, suicide, war, inhalation of gas or fumes, commission of a felony, and certain aviation activities other than as a fare-paying passenger are typically excluded. Also, the death must occur within a certain number of days (usually ninety) after the accident. And, the death must occur before some stated age, such as age sixty-five or seventy.

ACCIDENTAL DEATH & DISMEMBERMENT (AD&D)

The dismemberment benefit pays specified sums if the insured loses one or more limbs, or sight of one or both eyes, and in some cases hearing, as the result of an accidental injury.

It usually pays of the full principal sum in the event that the insured suffers the loss of two limbs, or the sight of both eyes, or the loss of one limb and sight of one eye, due to an accidental injury. Frequently, one-half of the principal sum will be paid for the loss of one limb or the sight of one eye. Some companies will also pay one-quarter of the principal sum for lesser losses, such as the loss of a finger. In order for loss of limbs to be covered, generally there must be actual severance of the hand or foot. Loss of sight is usually defined as irrecoverable loss of vision, and physical separation or removal of the eye is not necessary. Covered dismemberment losses must usually occur within 90 days of the accident.

WAIVER OF PREMIUM

One of the most commonly found and useful additional benefit is known as waiver of premium. It is actually a disability insurance benefit, which pays the life insurance premiums while an insured is totally disabled. The waiver of premium rider is very practical since it is inexpensive and keeps life insurance in force without premium payments.

This coverage is temporary and applies only to disabilities that begin before the insured reaches age 60 or 65. However, if a total disability begins prior to the age limit, the premiums will continue to be waived for the duration of the disability, even if it continues beyond that age.

Normally there is a six-month waiting period before waiver of premium benefits begin. An insured must be totally disabled for at least six months, and must continue to pay any premiums that are due within that period. Any premiums paid during the waiting period will be refunded to the policyowner, and all
future premiums are waived while the disability continues.

This coverage is very inexpensive. A small additional premium, usually about $1 annually per thousand dollars of insurance, is charged for this rider. The insured will be required to show continuing disability unless total and permanent disability has been determined.

**Definition of Total and Permanent Disability**

The definition of "total and permanent disability" is important to the insured and varies among insurers. A liberal definition states that the insured is totally and permanently disabled if the insured is not able to work at the occupation held prior to disability, even if a new job were found that paid as much or more money.

The most common definition of "total and permanent disability" however, is that the insured is disabled if the insured is unable to work at any job for which the insured is reasonably fit by education and training.

**WAIVER OF PREMIUM WITH DISABILITY INCOME**

This variation of the waiver of premium rider provides an additional disability income benefit. The same concept applies with respect to the definition of total disability, the age limitation, and the initial waiting period, but this rider also pays a weekly or monthly disability income benefit to the insured in addition to the life insurance premiums being waived. If the insured has a choice of the amount of the benefit (the number of dollars of disability income benefits per $1,000 of underlying life insurance), the premium charge will be greater for the higher benefit amounts.

**GUARANTEED INSURABILITY**

A guaranteed purchase option (GPO) protects the insured's ability to purchase life insurance in the future. The option states that no matter what the insured's health or occupation, at certain dates in the future, he or she may buy additional life insurance at standard rates. The typical option permits additional amounts of life insurance to be purchased every three years without evidence of insurability up to some stated age, such as forty.

The amount of insurance which can be purchased on the option dates is usually limited to the amount and type of the original policy. The rate for any additional insurance purchased will be the rate for the insured's then attained age, not the age at which the original policy was issued. The premium for the benefit would be in the $20-to-$30-per year range.

**RETURN OF PREMIUM**

This rider was developed primarily as a sales tool. The rider is simply an increasing amount of term insurance that equals the total of premiums paid at any point during the effective term period. The rider does not actually return the premium dollars paid for the base policy, but pays an additional death benefit equal to the amount of those premiums. The policyowner who purchases this rider is simply increasing the term insurance rider on top of the regular insurance policy.

**RETURN OF CASH VALUE**

This rider, which is similar to the return of premium rider, consists of increasing term insurance in an amount which is roughly equal to the cash value accumulation in a whole life policy. It was developed mainly as a sales tool to help agents overcome any objection to the fact that upon death a whole life policy pays only the face value.

The premium for this rider will be based on the age of the insured at the time it is purchased, and the amount and duration of the term insurance being purchased.

**COST OF LIVING**

This rider was designed to offset concerns about high inflation. It increases the face amount of a policy each year according to increases in an inflation index, such as the Consumer Price Index.

Some cost-of-living plans feature the automatic purchase of one-year term insurance whenever the CPI increases a specified amount. If the CPI does not increase (or does not increase enough), no additional insurance is purchased that year. The face amount never decreases below the face value.
amount of the original policy no matter how low the CPI drops.

One advantage of the cost-of-living policy is that evidence of insurability usually is not required. Another advantage is that the additional protection may be less expensive because agents' commissions normally are not paid on the additional insurance.

**ADDITIONAL INSURED**

Riders are also commonly attached to life insurance policies to provide coverage on the lives of one or more additional insureds. Usually these are term insurance riders or small amounts of additional whole life insurance covering a spouse, one or more children, or all family members in addition to the insured.

Although other family members can always be insured under separate policies, there may be advantages to using riders for this purpose, particularly when small amounts of insurance are involved. Administrative expenses are often reduced, which leads to lower cost for the coverage. For the insured, attaching additional family coverage to a base policy offers the convenience of a single premium payment, instead of payments for multiple policies.

**SUBSTITUTE INSURED**

Although the idea of substituting an insured may seem unusual in personal insurance planning, it is often desirable in business situations, when a key employee or executive is insured for the benefit of the business. Should this person terminate employment or retire, the insurance can be "switched" over to apply to the person's replacement. This allows the same policy to continue (avoiding termination and issuance of a new policy). However, the insurance company is likely to require evidence of insurability from a substitute insured, and will rate the coverage based on the new person's age and sex. A new contestability period may also be imposed.

**LIVING NEED -- ACCELERATED (LIVING) BENEFITS**

"Accelerated Benefits" and "Viatical Settlements" are two relatively recent developments in the life insurance field. Both concepts provide a means for an insured who has a serious or terminal illness to receive an advance portion of the proceeds to provide for medical care or living expenses during the final stages of life.

Accelerated benefits are living benefits paid by the insurance company which reduce the remaining death benefit available for the beneficiary.

Under a viatical settlement, the policyholder actually sells all rights to the policy to a viatical settlement company, which advances a percentage (usually 60% to 80%) of the eventual death benefit. The viatical settlement company then receives the entire death benefit when the insured ultimately dies.

The living needs rider is a relatively recent development in life insurance. In this case, a portion of the proceeds that would otherwise be payable as a death benefit is advanced to an insured who has a terminal disease and a need for special medical care. The benefit is designed to improve the quality of life for the terminally ill person during his or her remaining days. The funds are often used to ease pain, suffering and discomfort during the final period of life.

There are two basic types of accelerated death benefits riders:

- **Terminal illness rider.** This rider allows insureds with a life expectancy of six months or one year to collect part or all of the available proceeds.

  To be eligible for this benefit the individual must present medical proof of the terminal illness. Most companies offering this benefit will limit the amount of the insurance proceeds which may be paid in this manner.

- **Catastrophic illness rider.** Insureds who have certain catastrophic diseases, such as life-threatening cancer, coronary artery disease, or AIDS, can receive part of the face amount of insurance.

**LONG TERM CARE (LTC)**

A long term care (LTC) rider is another variation of the living need or accelerated benefits (paid in advance) concept. However, in this case the benefits are specifically targeted to apply to a variety of specified long term care services, and the

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insured does not necessarily need to be suffering from a terminal disease.

When the LTC rider is attached to life insurance, it allows an insured to borrow against future life insurance proceeds to provide current benefits for long term care. Most companies will allow up to 70% or 80% of the policy’s death benefit to be used in this manner. If a terminal illness is involved, some companies allow up to 90% or 95% of the death benefit to be used for health care and medical expenses.

A period of prior hospitalization may be required before an insured becomes eligible for long term care benefits, and there generally is an elimination period of 10 to 100 days before benefits are payable. Once benefits begin, the benefit period may be three-to-five years. Benefits are specifically designed to apply to such things as custodial care (assistance with chores of daily living, such as feeding, dressing, or bathing, provided by nonmedical personnel), skilled or intermediate nursing care (provided by medical personnel), and home health care (which may consist of medical and nonmedical care). Coverage may also be provided for adult day care and hospice care.

Although life insurance is generally intended to benefit survivors, it is more practical and humane to use life insurance proceeds to provide needed care to make an insured’s final days as comfortable as possible. The LTC rider is simply one method of making life insurance resources available for special care if the need arises.

Some insurers also have a benefit structure for their LTC rider which is like that of the disability rider, where a specified benefit (such as $10) is available per each $1,000 of face amount to pay LTC expenses.
TAX DEFINITION OF LIFE INSURANCE

A comprehensive definition of life insurance was established in 1984 which extends to all life insurance contracts issued after December 31, 1984. This is significant, as there had been no statutory definition established prior to this time. Basically, the law states that in order for a contract to qualify as life insurance for tax purposes, it must meet either (1) a cash value accumulation test or (2) a guideline premium and cash value corridor test.

CASH VALUE ACCUMULATION TEST

A policy meets the cash value accumulation test if the cash surrender value does not at any time exceed the net single premium which would have to be paid to fund future benefits.

TARGET PREMIUM

The minimum amount of premium needed to support both the minimum sum insured (pure insurance) and the cash value is called the target premium. This amount represents the level of funding the insurer recommends to maintain the policy. It is typically based on relatively conservative investment return assumptions and is usually comparable to premiums for a similar whole life policy. Most insurers base their first-year commissions on the target premium, paying up to 50 percent commissions on the target amount and a much lower percentage (3 to 5 percent is common) on excess premium amounts.

THE IRS CORRIDOR

A universal life policy must include an amount at risk. If the cash value approaches the face amount, the death benefit must increase so as to provide for this amount at risk. This minimum separation between the cash value and the death benefit is called the “risk corridor.” With the establishment of the Tax Reform Act of 1984, the law now states that the ratio of the death benefit to cash value at any time cannot be less than a specified percent. The face amount of a contract at age 40 or less can never be less than 250% of the cash value. This percentage declines steadily each year until age 95.

To maintain this minimum insurance corridor, insurers typically reserve the right to refuse additional premium payments if they would cause the cash value to increase beyond the upper limits relative to the death benefit.

If the policy meets the test, all death benefits from the life insurance contract would qualify for income tax-free treatment. However, if not, both the earnings on the cash value and the proceeds paid to the beneficiary will be taxable.

The IRS will get its share of the policy’s earnings, but only if and when funds are withdrawn from the policy. There is no tax payable if the policy pays the death benefit. And, because funds are usually withdrawn after the insured retires, the tax rate should be lower than when the insured was working, which is another financial advantage for the insured.

MODIFIED ENDOWMENT CONTRACTS

The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) defined a new class of life insurance products called “modified endowment contracts” and singled them out for unique tax treatment. These contracts are policies that qualify as life insurance under the statutory definition reviewed earlier but which fail to meet a 7-pay test.

If at any time during the first seven years, if cumulative premiums have been paid which exceed the cumulative funding limit at that point, the policy will be treated as a modified endowment contract (MEC) from that point on.

In the 4th year the policyholder paid more than the target premium. The policy would not, however, be a MEC at this point, even though the premium exceeded the target premium, because the cumulative total still meets the rules. However, the policy does become a MEC in the 5th year when the extra $200 pushes the policy over the cumulative total allowed. From that point on, the policy is a MEC. Even though the policyholder pays only $800 the following year bringing the cumulative total back in line. Once the policy is a MEC it is always a MEC.
If a policy is found to be a MEC, distributions from that policy are subject to unfavorable tax rules. Such distributions may be in the form of total or partial surrenders, assignments, pledges, withdrawals, policy loans or loans secured by the policy.

The rules for the taxation of distributions from MECs are as follows:

- First, all money withdrawn, loans, etc., are deemed to be income (excess of cash values over premiums) before capital. The policy holder can't recover his or her tax-free cost basis until after all income has been distributed out of the contract and taxed as ordinary income.
- Second, "premature" distributions from modified endowment contracts are generally subject to a 10% penalty tax, in addition to the regular income tax. A premature distribution is a distribution made to a nondisabled policyholder before age 59 1/2 in a form other than an annuity.

The new rules for modified endowment contracts generally apply to contracts entered into, or materially changed, on or after 6-21-88. While the rule was originally designed to combat misuse of single-premium life, it can affect any policy in which excessive premiums are paid in the early years.

Example:

The target premium is $1,000 per year:

<table>
<thead>
<tr>
<th>Year</th>
<th>Policyholder Premium</th>
<th>Cumulative Total</th>
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</thead>
<tbody>
<tr>
<td>1st and 2nd year</td>
<td>$1,000</td>
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<td>3rd year</td>
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<tr>
<td>5th year</td>
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<td>$5,200</td>
</tr>
<tr>
<td>6th year</td>
<td>$800</td>
<td>$6,000</td>
</tr>
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</table>
INCOME TAX TREATMENT OF LIFE INSURANCE

A full appreciation of the planning opportunities presented by life insurance requires a working knowledge of the income tax treatment of life insurance in general. Due to the scope of this course, a full discussion of taxation is not possible. Agents are encouraged to obtain additional information from, and/or refer clients to, tax experts for sophisticated tax, estate, or financial planning. The subject of taxation of life insurance is not always clear-cut due to some of the complex ways in which life insurance may be used. But some basic guidelines can be given to agents to enhance their understanding of how the tax laws work in general.

Life insurance proceeds represent a great deal of money, often the bulk of an insured's estate, so tax considerations become very important. While a tax attorney or tax expert should be consulted for advice on complex matters, a life insurance agent should have a basic understanding of how taxes may affect life insurance.

There are three unique tax advantages enjoyed by life insurance:

- With both term and permanent life insurance, the death benefit is usually not subject to income taxation.
- The cash value of permanent life insurance accumulates on a tax-deferred basis and is distributed income tax free if paid as part of the death benefit.
- Borrowing or withdrawing funds from the cash value is given favorable "first in-first out" (FIFO) treatment (except in cases where the policy is designated a Modified Endowment Contract).

DEATH BENEFITS INCOME TAX FREE

One of the most important advantages of life insurance, term as well as whole life, is the income tax-free nature of the death benefit. Section 101(a)(1) of the Internal Revenue Code states as a general rule that death proceeds are excluded from the beneficiary's gross income.

Life insurance proceeds may or may not be subject to federal income taxes and/or estate taxes. Generally, death proceeds from a life insurance policy are received tax free by the beneficiary, however there are exceptions.

With respect to federal income taxes, generally, the following rules apply:

- Lump sum settlements are not taxable as income, whether the policy is individually owned or business owned.
- Whenever life insurance proceeds are taken other than in a lump sum, part of the proceeds received will be tax free and part will be taxable. The basic concept is that each installment received is part principal and part interest, and the interest portion of the installment is taxable as income.
- If the policyowner decides to surrender the policy for the cash value at age 65, he or she will generally pay income tax only on the amount of cash value which is in excess of the total of the premiums paid (less dividends received in cash or used to reduce premiums). This is the cost basis.

TAX-DEFERRED CASH VALUE GROWTH

Permanent life insurance policies enjoy a special tax advantage. The cash value accumulates on an income tax-deferred basis, leveraging its growth. More of the insured's money is working for them than it would in a taxable savings or investment. Permanent life's tax-deferred growth makes the cash value an important policyowner asset.

FAVORABLE WITHDRAWAL TREATMENT

Another advantage of permanent life insurance is the favorable accounting treatment of cash value withdrawals and loans. The policyowner has the right to withdraw—either as a policy loan or, in the case of universal life insurance, through a cash withdrawal - a portion of the cash value.

Withdrawals up to the policy's cost basis are treated as tax-free returns of the policyowner's contributions. If the withdrawn amount is treated as a policy loan, even amounts exceeding the adjusted basis escape income taxation. However, failure to
repay the loan plus accrued interest reduces the death benefit ultimately paid.

If the policy is designated as a modified endowment contract (MEC), however, a different, less favorable tax treatment applies.

**ESTATE TAX CONSEQUENCES**

Although life insurance proceeds payable to a beneficiary are not subject to income taxes, they are frequently subject to estate taxes. The proceeds are subject to inclusion in the deceased's estate for federal estate tax purposes if the death benefits are payable to the estate, or if the deceased was the policyowner. This means that in all cases where the insured is also the policyowner, the benefits are included in the estate value even if payable to a beneficiary other than the estate.

Due to the large estate tax exemption, the tax consequences for many middle class families may be minimal. But if insurance proceeds are included in an estate, they also increase the gross estate value subject to taxation.

With respect to federal estate taxes, life insurance proceeds are subject to inclusion in the deceased's estate for federal estate tax purposes if any of the following apply:

- The estate was the named beneficiary, or
- The deceased was the policyowner, or
- The deceased ownership transferred the policy to another person within three years of death

Life insurance proceeds on the life of a top executive and payable to a corporation, under a policy owned by the corporation, would not be included in the deceased person's estate because the corporation was the owner and beneficiary (not the estate of the deceased).

However, many individually owned life insurance policies could be subject to estate taxes because the insured is often the policyowner. Under federal law a unified tax credit applies to gift and estate taxes, so estate taxes should only be a concern for those with assets greater than the federal tax credit.

If the policy is transferred into an irrevocable life insurance trust (and assuming the insured has no continuing incidents of ownership in the policy), the proceeds will not be recognized as part of the decedent's estate. (Again, readers are encouraged to obtain more information, as this is a complicated subject.)

One exception to the taxation of an estate is the marital deduction. An entire estate may be left to a surviving spouse with no tax consequence. However, this simply shifts or postpones the estate tax burden to the surviving spouse. When the second spouse dies, the assets in the estate become taxable. Through the use of trusts and other estate planning tools, the impact of this taxation can be minimized.

**CASH SURRENDER VALUE**

If a policyowner surrenders a policy for its cash value, some of the cash value received may be subject to ordinary income tax if it exceeds the sum of the premiums paid for the policy. Generally, the amount equal to premium payments is not taxable. Any additional amount in excess of the premium payments, the earnings on the cash value made would be taxable as income.

**TRANSFER FOR VALUE**

Lump sum Life insurance proceeds if transferred to a person in exchange for valuable consideration, (such as money, services, or something else of value), would be taxable as income.

**1035 EXCHANGES**

Under section 1035(a) of the Internal Revenue Code, certain exchanges of insurance policies and annuities may occur as nontaxable exchanges. Generally, if a policyowner exchanges a life insurance policy for another life policy with the same insured and beneficiary and a gain is realized, it will not be taxed as income under section 1035(a).

**POLICY LOANS**

Policy loans under life insurance policies are not taxable as income because they are treated as a debt against the policy. Under contract terms, policy loans must be paid back with interest in order to maintain policy values. Otherwise, outstanding loans reduce the death benefit.
**PREMIUMS**

When a business buys group term life insurance for its employees, premiums are generally considered a necessary business expense and are tax deductible. However, when a business buys life insurance to perpetuate the business (for example, under a buy-sell agreement, or key person insurance) the premiums are not tax deductible. Proceeds, however, are received tax-free by the business.

Premiums paid for individual life insurance are considered a personal expense and therefore not deductible from current income. However, since the insurance is purchased with after-tax dollars, taxes have already been paid and the benefits will not usually be subject to taxes.

**DIVIDENDS**

Since dividends are considered a return of excess premium paid by the policy owner, they are not taxable as income. However, any interest earned on dividends and accumulated by the insurer or paid to the policy owner is taxable in the year received.

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**SUMMARY**

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax Consequences</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Proceeds:</strong></td>
<td>Proceeds may be subject to Estate Taxes depending upon who owns the policy and who is the beneficiary</td>
</tr>
<tr>
<td>Lump Sum</td>
<td>No income tax</td>
</tr>
<tr>
<td>Installments</td>
<td>Interest portion taxable as income</td>
</tr>
<tr>
<td><strong>Cash Surrender Value</strong></td>
<td>Cost Recovery Rule (portion in excess of premium payments taxed as income)</td>
</tr>
<tr>
<td><strong>Premium Payments</strong></td>
<td></td>
</tr>
<tr>
<td>Individual -</td>
<td>Not deductible;</td>
</tr>
<tr>
<td>Group paid by employer -</td>
<td>Cost for the first $50,000 of life insurance is deductible for employer, and the cost for coverage in excess of $50,000 is taxable as income to the employee</td>
</tr>
</tbody>
</table>
ETHICS
Agents and financial representatives have both a legal and ethical obligation to be especially careful regarding representations made in life insurance sales presentations.

Those selling variable contracts must respect both the insurance trade practice rules of their state's insurance code as well as the NASD's rules on the solicitation and sale of securities. Agents must possess the knowledge and skill required to assist clients.

Selecting the market to sell is vital. Different markets require different degrees of expertise. Selling mortgage redemption life insurance requires little technical knowledge. However, handling a complex estate plan requires knowledge of tax laws and the need to coordinate life insurance with the other assets of the insured’s plan through attorneys and accountants.

**ETHICAL SELLING**

An ethical insurance agent that goes out of business because he or she could not bring in the earnings necessary to pay their bills will not do the consumer much good. Therefore, the agent must be both ethical and skilled in his or her trade. In fact, the financially successful agent will probably find it easier to be ethical since there will be less stress involved to make the sale at any cost.

Adhering to ethical principles may require the individual to forgo immediate financial gain. For many professionals, the benefits of ethical practices are far more valuable than immediate profit. In addition to the personal satisfaction of conducting their business with integrity, these professionals are contributing to the betterment of society. Adherence to ethical principles actually enhances long-term profits. Ethical practices will very likely be repaid many times over in referrals and endorsements.

**The Changing Role of the Sales Professional**

The role of the salesperson has changed dramatically as well as the concept of selling. At one time, the buyer was assumed to be responsible for ensuring that any purchase made was suitable and appropriate, and the use to which it was to be put.

If the buyer purchased an inappropriate, defective or otherwise unsuitable product, the problem was his or hers rather than the seller's. Any recourse required that the buyer prove the seller was at least grossly negligent or that they acted with intent to defraud.

Beginning in the 1960s, sellers took on greater legal liability for defective products. This reflected the greater number and complexity of products available, and a more consumer friendly legal system. No longer must a buyer prove negligence or intent to defraud on the part of the manufacturer or seller.

A far more ethical role envisions the sales person as a professional who assists the client in making decisions that will help to better ensure the client's health, safety and financial well-being, rather than an adversary, around whom the client needs to be wary.

Ideally both the sales person and the client should be jointly focused on the client's interests. This has contributed to making the sales professional-client relationship a fiduciary one, requiring sales professionals to make decisions involving their clients that are consistently ethical.

**SELLING TO NEEDS**

The most important duty of an insurance agent to a prospect is to be honest in his or her analysis of the prospect's valid needs. Companies and agencies should stress needs analysis for the various types of insurance. Agents must make sure they continue to follow the procedures they have been taught.

In the conduct of business or professional activities, an agent should not engage in any act or omission of a dishonest, deceitful, or fraudulent nature. An agent must not allow the pursuit of financial gain or other personal benefit to interfere with the exercise of sound professional judgment and skills.

Because the agent has specialized knowledge about insurance that the prospect does not possess, and because the agent is licensed and regulated by government authority in order to protect the public interest, the agent has assumed a duty to act in the best interests of the prospect. To act in the best interests of the prospect, the agent must take the time to evaluate the prospect's needs and recommend a product that best meets those needs and is affordable to the prospect.

Agents who take the long term view of their self-interest find that it does not compete with their
prospects' best interests. By putting their client's best interests first, they also serve their own best interests over the long-term. Not only do clients receive the products and service that truly meet their needs, but agents build the kind of clientele that will make them lifelong successes in the life insurance business.

**Suitability**

Suitability means that the purchase recommendations made by the insurance agent are based on reasonable grounds that are "suitable" for the customer. The National Association of Securities Dealers (NASD) defines suitability as "purchase recommendations that are based on information furnished by the customer about the customer's financial situation, needs, and investment objectives." Similarly, the Securities and Exchange Commission defines suitable recommendations as "those made on the basis of the client's needs, financial circumstances, and investment objectives."

Determining the suitability of a particular insurance product for a particular client is arguably the most important service the agent provides.

Several states have begun applying suitability considerations to life insurance and annuity sales. References to "suitability" also appear in other state laws having to do with sales of insurance products to senior consumers, such as Medicare supplement and long-term care insurance. The regulations generally specify that the agent selling the insurance must have "reasonable grounds" for believing the recommendation is "suitable" for the customer, based upon the customer's circumstances, risk tolerance, need for insurance, and existing insurance already owned. For example in California, agents soliciting seniors for long term care and Medicare supplement insurance must make "reasonable efforts to determine whether the purchase is appropriate for the client."

Such suitability requirements making it illegal for agents to sell products that are inappropriate for a client's financial needs, would impose a degree of care (and liability) on agents that has until now merely been implied.

Needs-based selling and ongoing client service are among an agent's primary responsibility to the customer. A needs-based analysis is the only way to ensure that the customer gets the insurance product that is most appropriate to his or her goals and needs.

Today's insurance consumers tend to be more sophisticated with regard to personal finance and investments, and also more cynical.

Successful agents inform and educate the client about the insurance industry and insurance products.

Agents should give the client sufficient information about how the insurance product being recommended meets the clients specific needs, and should always document the final outcome with a letter to the client that summarizes what was discussed, what was recommended, and what the client decided to do. Such follow-up letters can save an agent many headaches (not to mention errors and omissions problems) down the road.

In fact, an agent probably should document all client meetings with a follow-up letter, and should make notes on any conversations with the client or the carrier with regards to the client.

In securing coverage for the client, the main responsibility as an agent is to act reasonably under the circumstances. This means that they must also adhere to their ethical responsibilities to the insurer and see that the prospect completes the application accurately and completely.

At this point, the agent's primary responsibility is to the insurer since they are acting as its agent during the application process. The agent is responsible for obtaining full and accurate information necessary for analyzing the risk and the hazards and exposures involved in order to determine the prospect's needs accurately. Remember that the insurer is relying upon them for full disclosure of all pertinent information regarding the applicant.

Doing a 'needs analysis' is a fairly cut-and-dry process. However, when the human factor is brought in, needs analysis can be a challenge to an agent's ethical code. Faced with a client who simply doesn't want to think about possible loss, an agent may write a policy that represents an amount of insurance the client is willing to buy, rather than coverage of the client's own needs. When the person dies or becomes disabled, or when their house burns down and they are underinsured they will feel that the agent failed to do their duty.

Parents of children with physical, mental, or emotional problems may not want to face the fact that they must make provisions for the child after they are gone. Denial may take the form of pretending that the child will one day be able to take
care of itself. But an ethical agent must find a way to see that this very significant need is dealt with and met.

The agent has a responsibility to a client to service the policy with periodic reviews, and keep clients informed of any changes in insurance instruments or laws/regulations affecting the coverage.

Before an individual becomes a policyowner, he or she is a prospect. The transition from prospect to policyowner, and ultimately from policyowner to client, comes about when an agent follows two basic rules: sell to needs and service the sale. In doing so, the agent will also live up to the ethical duties he or she has to policyowners.

Fortunately, most agents recognize that specific types of insurance policies are designed to meet specific needs, and matching the policy to client needs produces the maximum benefit to the policyowner. They also know that needs selling involves problem analysis, action planning, product recommendation and plan implementation. This requires two important commitments on the agent's part:

- a commitment to the knowledge and skills necessary to carry out those tasks; and
- a commitment to educating the prospect or client about the products and plans that may be implemented on the agent's recommendation.

Client trust must be earned, nurtured and constantly reinforced. The agent must communicate to his or her client the reasons why a particular insurance policy or program is being recommended and how it will serve their needs. Individuals who understand what a particular insurance plan or policy will do for them are more likely to buy, more likely to be satisfied with their insurance and more likely to renew their policies. This communication and education continues long after the particular policy or program is sold and becomes part of the overall insurance program designed for that client. The professional agent has established his or her client's insurance program based on needs which should be reviewed periodically, supported by explanation and communication of the programs put in place to meet those needs.

The first duty of an insurance agent to a prospect is to be honest in his or her analysis of the prospect's valid needs. Company or agency training courses stress needs analysis for the various types of insurance, and agents must make sure they continue to follow the procedures they have been taught.

Because the very nature of insurance, that people are paying for a loss that lies in the future, or that they may never have, makes selling it more difficult.

Besides being honest and straightforward during the sales process, agents also have an ethical obligation to provide exemplary service to their clients. This includes staying in touch with customers and conducting periodic reviews of coverage and needs to assure that customers are adequately covered. In addition, agents should be aware that they are in possession of considerable private information about their customers. They should take care to protect the confidential relationship they have with their clients. Finally, unfair or inaccurate remarks about the competition must be avoided. Such remarks are not only illegal, but unprofessional. They reflect badly on the entire industry.

**The Professional Sales Process**

The sales process is the methods used to sell needed products and services to consumers. The sales process is the heart of any company’s distribution system. The sales process—from initial introduction to delivery of the product—may involve multiple meetings, and has four steps:

- Approach
- The opening and fact-finding interviews
- Recommendations and close
- Implementation and follow up

Basic to the success of the sales process is the salesperson’s ability to develop trust and create rapport with a prospect. Sales people’s ethics and values contribute more to the success of the sales process than any techniques or strategies they might use.

Selling is not something that a salesperson does to someone else; instead, it is something that the professional does for and with a buyer that results in an exchange of value. Elements in the sales process that create ethical concerns for the sales professional:

**Ethical Concerns in the Approach**

During this step, the two most ethically sensitive issues are:
• The way sales professionals represent themselves
• What is discussed between the sales professional and the prospect

As a result of the approach step in the sales process, the prospective client should have a clear understanding of the identity of the sales person, the products or services being offered for sale and the company or companies the sales person represents.

In the approach step of the sales process, the objective is to motivate the prospective clients to agree to disclose sufficient personal and financial information to sales professionals to enable them to determine if a need for an insurance or investment product exists.

During the approach step of the sales process, the important ethical issue is that, at no time, was the prospective client misled in any way.

The purpose of the approach is to develop rapport with prospects to cause them to come to perceive the financial sales professional as someone with whom they may want to do business.

How Sales Professionals Represent Themselves

The principal ethical concern in the approach step is that sales persons may state or imply that he or she has skills, experience or credentials that are not possessed.

Professional Credentials

Using the designations CPCU, CLU, CFP, ChFC or CPA is improper and deceptive unless individuals have earned them. Also, using a title such as "financial consultant," "financial planner," "investment planner," etc., is improper unless the individual is has the proper credentials.

Insurance agents, and other financial services practitioners, because of the personal nature of their business, must be viewed as both competent and credible before the prospective client will share financial information. Therefore, there is enormous pressure on financial sales professionals to appear knowledgeable and experienced.

For most financial sales professionals, this need for credibility and competence causes them to obtain professional education and experience. When that occurs, both the professionals and their clients benefit. However, if the need to appear competent causes sales people to misrepresent their credentials, experience or skills, it is a serious ethical problem.

A sales person who states or implies the possession of skills actually not possessed may result in his or her liability for failing to perform in the manner of someone who possesses such skills. If the sales person represents or implies that he or she has certain skills, failure to provide that level of service could make the sales person liable for any damages the client sustains as a result.

Some sales professionals use a trade name. While using a trade name is certainly acceptable, its use by sales professionals as a way of identifying themselves without also identifying the company being represented would be misleading. To the extent that it misleads, it is unethical. Any implication by the sales person that he or she is affiliated with the government, any governmental agency or credentialing organization in an attempt to suggest its approval of the sales person or his or her products is unethical and illegal in most jurisdictions.

Sales professionals must not represent themselves as financial planners, investment planners, consultants or advisors when, in fact, the practitioner is a life insurance agent or registered representative. Such a statement suggests to the prospective client that the practitioner provides unbiased analyses of client financial situations, with no conflict of interest. The selling of financial products clearly creates such a conflict. Without that statement concerning the conflict of interest, this title is misleading and unethical and may even be illegal in certain jurisdictions.

How Sales Professionals Represent their Products

One of the ethical requirements is that the information provided to prospects is balanced and complete and enable them to decide whether to work with the sales person based on truthful information. Any product discussion should result in complete understanding by the listener.

The real nature of the product as insurance should not be hidden or disguised. For example, the terms "plan," "program" or "private pension" when referring to a life insurance policy is unethical, and
in some cases illegal, because those terms obscure the true nature of the product, life insurance.

If the initial approach is made by telephone the sales person should usually avoid discussing specific products, because an adequate explanation in the relatively short space of time on the telephone is difficult. An attempt to discuss a complex financial product in this setting often results in misunderstandings and is more likely to cause confusion, rather than understanding.

**Ethical Concerns in the Opening and Fact-Finding Interviews**

This step is the first substantive meeting with the prospective client. In the opening interview, the agent will normally begin to develop rapport with the prospective client and begin to identify benefits that the individual would receive by proceeding to the next step, the data-gathering session.

The agent might suggest that they proceed immediately to the data-gathering session or schedule another meeting at which the data-gathering would take place and ask the prospect if he or she has family members or trusted advisers that the prospect would like to have attend the session.

It is common for insurance companies to use the services of celebrities and other prominent people for advertising purposes. Testimonials used in advertising must be applicable to the policy advertised and be given accurately. Such testimonials must indicate if the person giving the testimonial is being compensated or has any financial interest in the company.

Testimonial letters from satisfied clients are often used to motivate the prospect. It is important that any testimonial letters actually reflect the writer’s current opinion. Furthermore, if any payment was made for a testimonial letter, that must be disclosed to the prospect.

An insurance agent may choose to use visual or graphic material to inform the prospective client about the potential advantages and benefits of a product. When using graphics or other illustrations, it’s important to make sure that they do not mislead the prospect, and that the material matches the prospective client’s level of understanding.

Most insurers prohibit agents from using any materials unless they have been reviewed and approved by the insurer (and sometimes even the state) first.

**The Opening**

The ethical principles governing full disclosure require that the prospective client be fully apprised of the sales professional’s status as an advocate for a financial product or insurance. The prospective client has a right to know by whom he or she is being interviewed. If sales professionals represent a particular company, their status as representatives of that company must be disclosed. In addition, if sales professionals are registered representatives, they must identify the company and broker/dealer, and provide addresses and telephone numbers.

**The Fact-Finding Interviews**

The object of the data-gathering interview is to obtain sufficient information about the prospective client to develop a recommendation that is suitable to his or her situation, and consistent with his or her objectives and tolerance for risk.

The data-gathering step of the sales process presents the insurance agent with an ethical and legal duty to make a diligent effort to determine all the client’s circumstances that are relevant to his financial situation. In order to make a suitable recommendation, these circumstances include the prospective client’s current finances, as well as his or her desires and aspirations.

Whenever interacting with a prospective client, care must be taken to ensure that the agent doesn’t inadvertently lead the prospect to believe that they are providing services not actually provided. If the sales person becomes aware of any such misunderstanding on the prospect’s part, he or she is under an ethical obligation to correct it as soon as possible.

The tools that the financial sales professional uses could also lead the prospective client to the wrong conclusions. Using a data-gathering form which is entitled Financial Planning Form will lead clients to a conclusion that the sales person is in the business of providing financial advice. The sales professional has the responsibility to avoid anything that could reasonably be expected to mislead the prospect, and to correct any misperception of which he or she becomes aware.

During the data gathering session, the agent must
make every effort to fully understand the prospect’s situation. Without such an understanding, the agent will not be able to ensure that his or her recommendations are suitable for the prospect. An excellent way for the agent to check his or her understanding is to restate the prospect’s answer and ask if that is what he or she meant.

Ethical Concerns during the Recommendations and Close

The final step of the sales process is when agents make recommendations based on their assessments of prospects’ needs, and seek decisions from the prospects to purchase the recommended products. The principal ethical issues here are:

- The selection of a suitable product
- Product disclosure
- How the sales professional motivates the prospect or client (fear, guilt or other negative motivations are not considered ethical, particularly with seniors)

When making any insurance recommendations, several principles that should be adhered to:

- Recommendations must provide complete disclosure to the prospect of all material elements. All information—both positive and negative—that could reasonably affect the prospect’s buying decision must be disclosed.
- Recommendations should be balanced and identify both their advantages and disadvantages.
- A proper recommendation will include the benefits to be gained by the prospect, the costs involved and risks that would be assumed by the prospect.

Insurance products are complicated and require careful explanation. Any products or services recommended should be clearly identified and explained to the prospect. The explanations used for insurance products should avoid comparisons to other similar, but not identical, products or services. Any comparisons with competing products and services should be accurate, complete and fair.

Products or services recommended must meet a need acknowledged by the prospect and be suitable for the prospect with respect to his or her age, condition, financial situation and psychological disposition. It is unethical for an agent to sell an insurance product to a prospect that does not acknowledge that he or she has a need for it.

When the prospect has a limited comprehension of the basic insurance products and concepts, the agent should suggest that a family member or trusted adviser be a part of the meeting.

Insurance agents often use statistics as part of their recommendation. Any statistics employed in making a recommendation should be both substantiated and referenced to enable the prospect to learn more.

Any material that must be provided by the agent to prospects by law—buyer’s guides, prospectuses, etc.—must be provided in a timely fashion, before the sale is made. Supporting materials used in presenting the recommendation to the prospect or client must inform without misleading, and must:

- Enable the prospect or client to render a more informed decision with respect to the recommendation
- Be complete and balanced by disclosing both the advantages and disadvantages of the recommended course of action
- Clearly identify those elements of the recommendation that are not guaranteed, and those that are based on assumptions that may not be realized

Sales and Marketing

All states have laws prohibiting agents from engaging in unfair or deceptive acts or methods of competition with respect to selling and servicing insurance policies. The basis for many of these state statutes is the NAIC’s model Unfair Trade Practices Act, which expressly cites false advertising as an unfair trade practice and prohibits it. In this context, the term “advertising” is quite broad including almost any kind of communication or presentation used to promote the sale of an insurance policy.

The burden of complying with state insurance advertising laws rests on the insurance companies, since most advertisements or promotional pieces, regardless of the writer or presenter, are considered the responsibility of the insurer whose policies are being advertised. Most of the advertising and sales literature an agent uses is prepared by the insurer under the careful eye of its legal staff. For an agent, the ethical issue is not the material itself, but
how the material is used and the deceptive sales presentation that may result.

The insurance agent is key to the sale, marketing, underwriting, and delivery of insurance policies. Insurance agents and brokers remain the principal contacts for insurance consumers, and are expected to fulfill certain legal, professional, and ethical obligations toward their clients.

As a marketing representative of the insurer, it is the agent's responsibility to represent and market the insurer's products in an ethical and professional manner. This requires knowledge of various insurance products, learning about the prospect's insurance needs and problems, and how to treat these needs with the proper insurance products. Agents can be a valuable resource, providing helpful guidance on the most appropriate use of a family's assets and allowing them to achieve financial goals such as risk management, retirement planning, death protection, health care, asset protection, etc.

Sales Tools

Insurance professionals use a variety of tools and methods to create interest in purchasing or keeping the products or services they sell or provide to people. These tools and methods must be used to foster clarity and disclosure to avoid creating ethical concerns.

Sales tools include almost everything that professionals use to communicate with prospects and clients, including presentations, sales and seminar scripts, brochures and product illustrations. Every communication designed to influence a decision to purchase a product by prospects or clients should be considered a sales tool.

Insurance companies have become much more concerned about the sales process, especially the sales materials used in the field. Many companies now require home office approval before any sales materials may be used.

Advertising and Sales Literature

Ethical advertising, regardless of its origin, is the responsibility of the insurer. Advertising information must not be obscure, ambiguous, deceptive, or misleading and must be truthful and accurate.

The purpose of state laws governing advertising and sales literature is to provide full and fair disclosure of all material information. In the past, sales and marketing practices were deemed unfair, including the companies failure to responsibly monitor and discipline its agents for improper sales activities.

Companies must also establish clear lines of communication, control, and responsibility over the dissemination of advertising and promotional materials by company officials whose compensation is not linked to sales.

States usually require that advertising and sales material may not omit information or use statements which are misleading to potential buyers. Advertisements cannot use jargon or terminology that would be confusing for a person not knowledgeable about insurance coverages. An advertisement cannot use language which exaggerates benefits or fails to disclose policy exclusions or limitations. In fact, most states require the insertion of specific wording for consumer protection.

Other ethical advertising standards include the following:

- It is misleading for an advertisement to imply or state that an insurer or a policy has been approved or endorsed by an individual or, a group, unless it is in fact true
- Statistical information used in advertising must accurate and reflect all material facts. Usually, the source of the statistical information must be disclosed.
- It is unethical and misleading if advertisements mislead the public with regard to the purpose of the policy, benefits to be derived from the policy or falsely identifying the type of policy being advertised. For example, referring to a life insurance policy as an investment product or retirement plan.
- Life insurance advertising must not imply or state that policy dividends are guaranteed. Nor may any sales literature or proposals combine guaranteed policy values (such as the cash value) with dividends which are not guaranteed.

Many states require the company to keep a record of advertisements used in the state; this would include advertisements used by agents. An interesting question arises with regard to independent agents who represent several companies and advertise under their own names.
In many states an agent cannot advertise a product under their name alone. Any advertisement must contain the name and sometimes the logo of the insurer as well as that of the agent.

**Advertising and Other Communications**

Advertising includes advertising in print and other media, as well as:

- Direct mail
- Flyers and handouts
- Personal brochures
- Posters
- CDs
- Websites
- Internet advertising

Advertising and other communications such as e-mails and websites may present special ethical challenges, especially for insurance or financial sales professionals. The reader must not be misled in any way by the ad or communication.

Advertising and sales literature sometimes cater to the consumer preference in a dishonest manner for the biggest or best product. People who fail to read material carefully are often misled by such advertising and sales material. Honesty requires that in these media no superlatives be used that are not demonstrably true.

Sales people sometimes attempt to motivate readers to act immediately by stating the product or service is available, or at a particularly low price, only for a limited time. While there is nothing ethically suspect about such a claim if it is true, the use of this language in an advertisement or sales literature when it is not true is dishonest and unethical. All advertising pieces and sales literature that the professional uses need to be examined to ensure that any exaggerations and ambiguities are removed.

**Motivation of Prospects and Clients**

It is also unethical to attempt to motivate prospects and clients by using fear, guilt or other negative emotions.

Ethical sales professionals seek to help prospects and clients to accurately identifying their real needs and goals. They conduct an objective and comprehensive effort to gather facts and information. Only then are sales professionals in position to determine what products and services to ethically propose to prospects or clients.

**Words**

The advertising industry has long been aware that many consumers are conditioned to more quickly recognize certain words, such as best, biggest, greatest and other superlatives -- while ignoring the meaning of other important words like may. For this reason, words such as the following should be scrupulously avoided, unless there is clear evidence that their use is accurate and appropriate:

- Special
- Full
- All Risk
- New
- Comprehensive
- Unlimited
- Best
- Generous
- Low cost

‘Puffing’ occurs when a sales person presents a product in an exaggerated manner by describing a product as new, best, unique or revolutionary. These and other superlatives, such as lowest cost, lowest risk, safest and similar words could mislead the reader. Legally and ethically, this language must be scrupulously avoided, unless its truth can be verified.

**Using Ethical Language in Ads and Direct Mail**

The objective of an ad or direct mail piece is to generate the maximum interest possible in the products and services highlighted. However, ads, direct mail and other types of mass communication may cause ethical problems.

Special care must be taken to present the material in a clear and honest way that prospects and clients can understand. To accomplish this, sales professionals must ensure that they use language that is:

**Truthful**

Normally, it is impossible to make a full disclosure in an ad or piece of direct mail; there just isn't sufficient time or space available. This makes it difficult to include qualifying information that might be necessary to a complete understanding of the
offering. As a result, complete information concerning exclusions, conditions and other limitations is not included. To prevent an ethical breach, sales professionals must take particular care to ensure they do not inadvertently misrepresent either the product or themselves through puffery.

Other terms that are potential ethical breaches are tax-free, tax-favored, tax-advantaged, tax-advantaged or words that point to the tax benefits of life insurance or other products that offer special tax treatment should not be used without additional qualifying language that advises readers to check with their tax advisors for applicability in their specific situations. Because of the lack of space and time to provide complete disclosure in advertising and direct mail pieces, it is a good idea to avoid discussing specific products or features in them.

**Modifying Sales Tools and Methods**

Based on statistics from the U.S. Bureau of the Census, the number of U.S. residents over age 65 has grown substantially and appears likely to continue to grow. Furthermore, the fastest growing segment of the population is made up of those individuals age 85 and older.

Not only is the current senior market large, its size is projected to double in the next 30 years. This market growth is the result of general population growth and the discovery of drugs and medical treatments that have tended to prolong life. However, some members of the senior market have certain limitations that need to be taken into account during sales and service.

The senior market is often viewed as a potentially lucrative one for sellers of financial products and services. Due to a concentration of wealth, however, the senior market is marked by a disproportionately large percentage of members with limitations, both cognitive and physical. Because of that deceitful practitioners target the senior market more frequently than any other age group.

Changes may need to be made in the sales professional’s stationery, business cards, advertising, etc. to ensure that they are readable and understandable by prospects with age-related limitations. In addition, the methods that the sales professional employs in the sales process may require modification to meet the special needs of seniors.

**Stationery and Business Cards**

How sales professionals identify themselves on their business cards or letterhead is important because these are typically the first pieces of sales material received by prospects or clients. States often have very specific laws regarding stationery and business cards used by insurance professionals. Some companies may have additional requirements. At a minimum sales professionals’ letterhead and business cards should include:

- Sufficient information to adequately identify them and the company they are representing without misleading the public.
- The fact that they are insurance agents and their insurance license number
- The address and telephone number of the sales person’s local office and, if part of a larger organization, show the name, address and telephone number of that larger organization, and most states require their license numbers as well.

**Complete and Honest Presentation**

Any presentation that gives a prospect or client the wrong impression about any aspect of an insurance policy or plan is deceptive. Any presentation that does not provide complete disclosure to a prospect or client is deceptive. Any presentation that includes misleading or inconclusive product comparisons is deceptive. Even if the deception is unintentional, the agent has committed an unethical and possible illegal act.

Helping clients to understand how the insurance policy they buy is tied to their particular needs is an important responsibility for an agent. Clients should also expect that the agent will contact them.
regularly to review the needs analysis, and to make any changes required.

Educating the client begins with the application process. In many cases, the client will be required to sign authorizations for:

- Medical Information Bureau reports
- Inspection reports
- Credit reports

While some people sign these authorizations with no objection, many people feel that such reports are an invasion of their privacy. It is up to the agent to explain the necessity of such reports in the underwriting process, and also to stress the confidentiality of the information thus obtained.

The application process also offers opportunities for unethical behavior on the part of the agent. The agent may exclude negative information in the hope they will either get a questionable risk placed or obtain a lower premium than what should be paid. If a claim happens, however the policy may not pay, because the client concealed information vital to the underwriting process.

The agent may lose the sale if the client refuses the policy on the grounds that the rated premium is too high. Professionals are not concerned with sales. They are concerned with service. Ethics demands honesty in every instance.

The average insurance buyer knows very little about insurance and therefore relies on the advice and recommendations of the insurance agent. By the time a consumer discovers that a particular policy does not meet his or her needs or does not live up to the agent's promises, it is probably too late to purchase another. The potential for deception by companies and agents alike is significant and the consequences to the consumer can be quite catastrophic.

The insurance buyer can suffer because of a misunderstanding about a policy's terms and conditions. If a loss goes uncovered because the agent or broker did not fully understand the risk, the buyer suffers, and the industry suffers. The agent must is to fully understand the insurer's policies and forms and also be aware of its underwriting, pricing and claims settlement practices. An agent's duty is to present each policy with complete honesty and objectivity, pointing out any limitations, exclusions or drawbacks the product may have, along with its features and benefits. In all cases, a simple, straightforward explanation of the policy and how that policy will help fit the prospect's needs is always the proper ethical course.

**Disclosure**

An agent is obligated to fully disclose all information that may affect the insurer and its ability to conduct business. Full disclosure is most important during the application and claims handling processes. An agent must complete all applications and claims forms as accurately and completely as possible. Failure to do so could lead the insurer to follow a course of action it would not otherwise take (such as issuing a policy to an applicant whose bad driving record had been concealed). It is the agent's or broker's responsibility to see that the answers to questions on the application are recorded fully and accurately.

Disclosure means informing the prospect or client of all facts involving a specific policy or plan, so an informed decision can be made. This helps meet other goals, too, by helping the client:

- select the most appropriate policy to meet his or her needs;
- understand the basic features of property and casualty insurance; and
- evaluate the relative costs of similar plans offered by a competitor.

The sales professional is ethically obligated to disclose any and all information that may be material to the prospective client to allow him or her to make an informed decision. A sales professional should document the file showing the information given to the prospect. The sales person should provide any material information in written form, even if it is not legally required.

Material information is any information that can reasonably be expected to affect a prospective client’s buying decision including:

- Benefits of the recommended plan
- The costs involved in the recommendation, including any that may not be obvious.
- The risks and consequences of the recommended purchase

In the old days, sales persons where expected to simply show prospects the benefits they could expect to receive by purchasing a product or service. It was up to buyers to discover any disadvantages attached to the transaction.
Today not only are sales professionals ethically called upon to disclose the benefits of the purchase, they are also required to disclose any fees or risks associated with it. The objective is to enable the prospective purchaser to make an informed decision, understanding both the advantages and disadvantage of the purchase.

It is becoming quite common to attach disclaimers to each and every application and/or policy and to require clients to sign it, in advance of services. Before using any disclosure letter, agents should speak to an attorney for approval.

To the extent that any material facts are withheld, or are presented inaccurately, the responsibility for the purchase decision shifts from the prospect to the agent. If the prospect makes a purchase decision while not in possession of all the material facts, and things later do not turn out to the prospect's satisfaction, the agent can be held liable.

Agents must disclose to clients any hidden conflicts of interest that might be perceived to affect the recommendations the agent might make. If a conflict of interest remains hidden at the time an agent makes a recommendation, it casts doubt on the agent's motives. By disclosing conflicts of interest, agents show that they are being completely straightforward and allowing clients to evaluate all aspects of the transaction.

Agents must be sure to fully disclose all relevant information when filling out an application. They protect their principal from issuing policies that should be rejected, or not charging an appropriate rate for the exposure.

Between agent and insurer, the obligations and duties of both should be:

- Fully disclosed in the agency agreement,
- Fully disclosed in the general agency agreement, or
- Explicitly detailed in other written documents.

Insurance agents have a duty to fully disclose to the insurer all material facts concerning an applicant or policyowner, or situations involving either, in order to assist the insurer in making any decision regarding a risk. At the same time an agent has the ethical responsibility of full disclosure to a prospect or client.

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**STANDARDIZED DISCLOSURE MATERIALS**

**Disclosure Letters and Disclosure Forms**

In disclosing the benefits of an insurance policy, an agent must describe the risks as well. Agents must present fair product comparisons of products. It is best to keep explanations clear and understandable and to use written disclosure forms (sign-off forms) and disclosure letters (follow-up letters) to protect all parties - agent, consumer, and carrier - from misunderstandings.

A disclosure form describes the product being sold and how it applies to the consumer's needs. This form, which is signed by both the agent and the client at the conclusion of the actual sales presentation, ensures that all relevant disclosures have been made during the sales presentation. This includes:

- Information about the insurance company
- A full description of the policy(ies) presented (including exclusions, limitations, and any charges such as surrender charges or cancellation charges)
- The "free look" period (for life and health policies)
- The Policy Summary (or Outline of Coverage)
- Buyers Guide and other mandatory guides or pamphlets required by state or federal law.
- Any illustrations used (and a statement that illustrations are estimates and not guarantees of future results)
- A Prospectus (if a variable product was presented)

If the policy is a replacement policy, the sign-off form should attest that all replacement procedures were properly followed and all replacement forms reviewed and completed.

A disclosure letter can be mailed to the consumer following a sales presentation. It should summarize what was discussed at the presentation, what types of insurance products the agent proposed to the prospective client, and what final decisions were made. It is important to include documentation of the sales process that was used, the risk assessment performed, the reasons for the recommendations made, any product comparisons that were made, details about the policies
recommended, and discussion of any illustrations used.

Disclosure letters and forms help establish that the agent has explained all product features as required by state law. They give the client the opportunity to confirm that he or she understands what has been presented and what has been purchased. They also reduce the possibility that the client will later claim that he or she did not understand what was being purchased.

**Telephone solicitation**

Federal and state laws regulate solicitations conducted by telephone. Agents who make telephone solicitations must identify themselves as insurance agents and identify the insurer they represent.

Using standardized disclosure materials can help agents assure that they are consistent, accurate, and complete in the disclosures they make to clients. In some cases, standardized disclosure materials may be required by state law.

Most of the states in the U.S. require by law that agents provide clients with a Buyer's Guide so that comparisons with other products may be made for certain types of coverage.

The benefits of providing complete disclosure to clients include the following:

- It builds trust and strengthens the agent-client relationship.
- It makes the agent's work easier, more enjoyable, and more profitable.
- It minimizes the chance of misunderstanding and future conflict.
- It makes the client responsible for the purchase decision, reducing the agent's potential liability for errors and omissions.

**ONGOING SERVICE, ONGOING DISCLOSURE**

As long as an individual remains a client, the agent has an ethical obligation to disclose material information to that client, including a periodic reassessment of the client's needs as well as updates on the performance of policies in force. Ongoing service and ongoing disclosure transform a single sales transaction into a lifelong relationship.

**SPECIFIC DISCLOSURE ISSUES IN LIFE INSURANCE MARKETING**

A number of the issues have a disclosure-related aspect. For example, consider the following.

- Policy illustrations in sales presentations.
- Replacement.
- Conflicts of interest.

**Adverse Tax Consequences**

Agents must be sure to disclose any adverse tax consequences involved in a life insurance purchase. Such consequences are material to the prospect's decision and must not be omitted. In our earlier discussion of replacement, we mentioned that agents should evaluate whether a replacement will result in any taxable gain to the policyowner.

**Modified Endowment Contracts (MECS)**

Another example would be the funding of a life insurance policy with a large premium in any of the policy's first seven years. This could cause the policy to be treated as a Modified Endowment Contract (MEC) for tax purposes. The tax treatment of policy loans and surrender proceeds from a MEC differs significantly from the treatment of loans and surrender proceeds from a life insurance policy.

- Policy loans taken from a life insurance policy are not considered to be taxable income, but policy loans taken from a MEC are.
- Partial surrender proceeds from a life insurance policy can be considered a non-income-taxable return of the policyowner's cost basis until the entire cost basis is withdrawn, but partial surrender proceeds from a MEC are considered a taxable withdrawal of the gain in the policy until all the gain is withdrawn.
- In addition, taxable amounts borrowed or withdrawn from a MEC may be subject to a 10% penalty tax unless certain exceptions apply to the policyowner's situation.

The agent should make sure that the client understands these potentially adverse tax consequences before purchasing any life insurance.
policy whose proposed funding pattern would cause it to be considered a MEC.

**Using Policy Loans to Create Tax-Free Income**

One of the unique tax advantages of cash-value life insurance is that policy loans are not considered to be taxable income to the policyowner. If the insured dies while a policy loan is outstanding, the policy loan is repaid with a portion of the death proceeds and none of the amounts borrowed from the policy ever become income taxable to the policyowner. Under these circumstances, it is possible for a policyowner to use policy loans from a cash-value life insurance policy as a source of tax-free income.

However, clients should also be made aware of the potentially severe adverse tax consequences. If a life insurance policy lapses or is surrendered, any outstanding loan is considered a taxable gain. Depending on how much was borrowed from the policy, this can generate a large tax bill. In the case of lapse, the policyowner may be stuck with a big tax bill and no resources from the policy with which to pay it.

Borrowing against a policy too heavily can cause it to lapse. What begins as an attractive tax benefit can end as a huge tax liability. To guard against lapse, only a relatively small proportion of the policy's cash values should be taken as policy loans, leaving substantial cash values that can sustain the policy in the event the insured lives to an advanced age.

As long as the client has a need for a substantial death benefit, the secondary benefit of using life insurance policy loans as a source of tax-free income may be worth the risk of the adverse tax consequences. To the extent the client does not have a need for a substantial death benefit, the tax risks outweigh the tax benefits. In any case, it is up to the client to decide. If an agent proposes that a life insurance policy be used as a source of tax-free income, he or she must be sure to point out the potentially adverse tax consequences as well as the potential tax benefits.

**Pension Maximization**

Pension maximization is a technique for making sales to persons covered by an employer-sponsored pension where they work. If those persons are married, at retirement they will have a choice of obtaining a benefit payable for as long as they live (single life), or for as long as either they or their spouse lives (Joint-and-survivor).

The benefit based on the joint-and-survivor benefit may be anywhere from 10% to 30% lower than the benefit based on the single life. If these individuals take the lower joint-and-survivor benefit and their spouse dies before they do, they generally are still locked into the lower payment for the remainder of their life. However, if they take the higher single life benefit, these individuals risk leaving their surviving spouse with nothing if they die before their spouse does.

In some cases, these individuals can resolve this dilemma by insuring their life for an amount adequate to provide their spouse with a benefit equal to the survivor benefit provided by the pension plan. With their spouse provided for in the event of their death, these individuals are then free to elect the higher single life benefit from the pension plan.

Pension maximization can be a great concept, but agents have an ethical obligation to do thorough fact finding and to fully disclose the elements that may affect the results of a pension maximization proposal for a particular client.

Agents who use pension maximization must always make sure that the amounts of coverage they recommend will meet the needs of their clients. They have an ethical and legal obligation to completely and accurately disclose the costs and benefits of the proposed pension maximization plan.

**Presentations, Illustrations, and Quotes**

It is illegal to induce a client to purchase or replace a policy by using

- presentation materials,
- illustrations, or
- quotes that are materially inaccurate.

**Presentations**

The presentation is a critical step in the sales process, since it presents the prospective client with a solution to a need that he or she has. It is the matching of an insurance or investment product to the prospective client’s requirements.
The most important requirement with respect to product selection is that it must be suitable to the prospective client’s circumstances and needs. When an investment product is recommended, the NASD’s “Rules of Fair Practice” require that it be suitable for the prospect’s financial situation and needs. Ethically, this suitability criteria should apply to all financial transactions involving a financial product considered either a security or insurance.

If the product being recommended is a stock or bond, the sales professional needs to identify it as such. If it is a mutual fund or a life insurance policy, the prospective client must be informed. Referring to the recommended product by a name that disguises its true nature to the prospective client is unethical, illegal and indicates a lack of competence.

Selling often involves educating the prospective client. One common method of educating is to use analogies to explain the unknown in terms of what the prospect already knows. Analogies should not be used to explain how a particular financial product works, since this method involves a high probability of misleading the prospect. The ethical concern is that the analogy often omits important information leaving the prospect with an incomplete and erroneous understanding of the product.

Recommendations

Sales professionals selling any product or service are accustomed to making recommendations for what they sell.

The principal ethical issue is that recommendations can easily be misleading to prospects and clients. Insurance recommendations are generally based on a needs analysis done for the prospect. The agent customarily provides a written proposal and a product illustration. The illustration may be based on a series of assumptions that may or may not be realized. If those assumptions do not come to pass the results shown on the illustration will not be attained.

When making recommendations and providing illustrations of the products being recommended, ethically the professional must:

- Make a balanced presentation of both the benefits provided and the cost or risks of those benefits
- Identify the risks, if any, to the prospect or client, including the risk that assumptions will not be realized
- Explain the assumptions upon which the illustration is based and the probable results of any deviation from those assumptions
- Provide a paper copy of the illustration and recommendation for the prospect

The comparison of alternative investment or savings vehicles must be approached carefully. Any comparison of financial products that are dissimilar must compare any differences between the products in the areas of:

- Risk
- Guarantees
- Insurance
- Tax features
- Any other important feature

**POLICY ILLUSTRATIONS**

Computer-generated ledger illustrations are especially sensitive to the need for realistic assumptions and full disclosure. NASD regulations and policies clearly restrict securities firms from projecting the future value of any security, including a mutual fund, in any part of its solicitation. Life insurance, on the other hand, is largely defined by the growth of policy values and projecting future growth is a standard practice in life insurance sales. The NASD prohibition against growth projections in the sale of securities does not preclude life insurers from projecting the growth of future policy values, though state insurance laws and regulations exercise a high degree of control over this important issue.

Basing the illustration on realistic financial and economic conditions is the best defense against possible future charges that the product's sale was made on the basis of unrealistic expectations. Many consumers regard policy illustrations as reliable indicators of future policy values. Financial representatives have the responsibility of making sure their illustrations are realistic and explaining to their prospective clients that the illustrations are purely hypothetical in nature.

Provided all policy charges are reflected and a realistic average investment return assumption is used, illustrations can provide a reasonably accurate picture of policy values in the future, as long as the consumer understands the uncertainty surrounding the projected values.
It is at this time that the service and advice of an insurance agent become important. Agents can help guide the consumer in determining what combination of policies and riders are appropriate for addressing the individual's temporary and permanent insurance needs.

Helping prospective clients make the right choice when considering life contract is easier if one observes the following rules.

- An informed consumer is your strongest marketing tool. Consumers who clearly understand the contract are your best prospects.
- Emphasize the concept, not the numbers. The danger of a prospective client placing too much faith in a ledger illustration can be minimized by relying less on projected numbers and more on explaining the underlying concept of the policy, in terms of needs and benefits the consumer will understand.
- Make sure there is a need for life insurance protection. While some policies include notable investment features, these should be promoted as an enhancement to the underlying life insurance product.
- Determine the consumer's risk tolerance. Use a questionnaire to determine the prospect's risk tolerance profile, then explain how the program recommended by you conforms with their profile.
- Keep good notes. Copies of illustrations, risk tolerance questionnaires, correspondence and other correspondence or notes regarding conversations with clients, will provide at least some protection against potential later charges of misrepresentation.
- Maintain good client contact after the sale. Periodic correspondence with the client will give the client an opportunity to express concerns and be reminded of important services.

Life insurance agents customarily use illustrations to sell insurance products. An illustration has considerable potential for ethical lapses.

The illustration may be used to show the possible growth of cash values, dividends and death benefits of a life insurance policy or it may show the historic growth of a security. Regardless of its intent, the important ethical principle is that the information provided must enable the prospect to make an informed decision.

The prospect must be able to properly assess the product and its suitability for meeting his or her need. This information is necessary to better inform the prospective client so he or she will be able to make a fully-informed decision. A fair and balanced comparison that details the pros and cons of each product, along with a detailed examination of their similarities and differences, is the only ethical way to do that.

**Balanced**

A balanced comparison is one that compares all the important features of the products, including the advantages and disadvantages of each. It should be obvious that an intentional misstatement concerning a competing company or product is unethical but it may be less obvious that the omission of material information would also be unethical and possibly illegal. The seller must point out to the potential buyer any negative features of the product. Failure to do so is an ethical breach and may result in the imposition of damages.

A sales professional may sometimes find it desirable to present supporting or ancillary information to prospects. These supporting illustrations must meet the same requirements as illustrations provided by insurers. They must be:

- Accurate
- Balanced
- Complete
- Presented in a manner that the prospect or client can understand.

An unbalanced illustration is one that presents only one side or part of the story, for example showing the advantages and benefits of a product or strategy without giving equal attention to any costs or disadvantages. Another type of unbalanced illustration would be one that unfairly compares the features of one companies’ products to another.

**Complete**

A comparison must compare all the important features. Statistics are often necessary and helpful when comparing products or companies, however they must be substantiated and referenced whenever they are used sales professional must put them also in terms and visuals that the average consumer can understand.
Risk Disclosure

Prospects and clients vary substantially in their level of comfort with risk which applies to the products they prefer and to the strategies they are willing to implement. When discussing strategies or products that involve risk, the key ethical consideration for the financial sales person is appropriate risk disclosure.

The competent insurance agent or registered representative should fully understand the risk involved with a proposed strategy. The salesperson’s failure to advise the prospective client of the risks inherent of any recommended strategy is unethical and possibly illegal as well.

Agent Presentation

Insurance policies are often complex and difficult to understand. Most agents’ presentations include some standard information regarding premiums, benefits, agent services and information regarding the company. Usually premiums are the biggest concern of the consumer and the discussion concerning premiums often takes up a majority of the agent’s presentation.

However, the majority of the E&O claims filed against an agent are related to the policy coverages and benefits, and how they were explained to the client, particularly the exclusions and/or limitations in the policy. This is one area where most agents need to do a better job.

Insurance contracts and premiums can be very confusing to the consumer. It is important that the agent discusses all options with the client and makes sure the client totally comprehends the concepts discussed.

The insurance contract is also intimidating to most clients. It is technical, complex, and rarely read fully by the insurance agent or their client. This is where many misunderstandings take place. It is important for the agent to stress to the client not only what claims the company is willing to pay, but also the conditions and limitations in the policy.

When replacing an existing policy the eligibility of an applicant (and their dependents) is always a concern. Continuity must be taken into consideration when replacing any type of policy. The existing plan should not be replaced until the new one is in force. The new policy should be thoroughly reviewed before the existing plan is dropped.

The presentation of a policy is also important, since many consumers do not understand the insurance business and the terminology involved. The agent needs to present the policy so that the client can understand all aspects. This is why communication skills are extremely important in the insurance industry.

Life insurance illustrations show hypothetically how the policy would perform under a given set of financial assumptions. A copy of any product illustrations shown to prospective clients should be provided to them for their files, the sales professional should make it completely clear that the assumptions upon which the illustration is based may not be true in the future. Life insurance dividends, costs and interest rates will almost certainly be higher or lower than shown. The non-guaranteed nature of any element in an insurance product or investment must be clearly explained to any prospective client before any sale takes place.

Vanishing premium

A life insurance policy in which policy dividends pay the entire premium at some point in the future is often called “vanishing premium”. The use of such a term, however, is misleading and should be avoided.

Life insurance agents who propose “vanishing premium” life insurance should illustrate how the policy would perform if the dividends or interest is actually lower than illustrated. To do that, agents would be required to run the illustration with a conservative dividend or interest.

Life insurance agents are ethically required to explain that the premiums do not really stop. Instead, premiums continue, but are simply paid by policy-generated dividends or excess interest, whose use in that way will reduce the policy’s total cash value. Furthermore, sales professionals need to explain that premium payments might resume if the declared dividends or credited interest rate is lower than that shown in the illustration.

Tax-advantaged Products

A statement that an insurance policy offers income and estate tax advantages could easily mislead prospective clients. Complete disclosure requires that any mention that any insurance product is tax-
advantaged must include a full explanation of the conditions required to qualify for those tax advantages

**Product Illustrations Provided by the Insurer**

Insurer-provided product illustrations usually present few if any ethical problems, because the insurer that provides them ensures that needed disclosures and explanations are included. Ethical issues usually arise when the illustration is created by an outside vendor, or by the insurance agent. Insurers often prohibit the use of any illustrations, unless the sponsoring company has created or approved them in advance.

Agents should use only the computer illustrations and sales materials provided by the insurers for each specific product. An agent should not, under any circumstances, use illustrations or other materials created by the agent, unless the insurer has reviewed and approved them. Insurance agents have an ethical and legal duty to those companies they represent and could be held liable for their acts by virtue of the law of agency. In addition agents must be careful to follow all laws regarding advertising in each respective state. In some cases advertisements must be approved by the state before they can be used by agents.

**Ethical Issues Surrounding Illustrations**

An important ethical issue in the life insurance industry is the appropriate design and use of life insurance policy illustrations. Concern over this issue has been voiced by a wide range of industry stakeholders: from individuals at all levels of the life insurance industry, and from persons outside the industry as well as inside it.

During the 1980s, the proliferation of computer technology made policy illustrations quickly and easily available to agents. Running a policy illustration became an automatic part of every sales proposal for many agents. Running a policy illustration for every proposal is not a recommended sales practice.

As agents got comfortable using policy illustrations, they moved away from the traditional life insurance sales process of identifying customer needs and then selling a product to meet those needs. In needs selling, the death benefit of the life insurance policy takes center stage, and cash values play an auxiliary role. Prospects are naturally attracted to cash values more than death benefits, so a lot of life insurance sales began to be made on the basis of those cash values rather than on the death benefit.

There is nothing unethical about pointing out the living benefits of cash value life insurance, but it must be done in conjunction with a discussion of the policy's death benefit. Death benefits should take center stage in an agent's sales approach because the primary purpose of life insurance is to provide a death benefit. Talk about life insurance cash values is generally unethical until the need for a death benefit has been established.

In addition to needs selling, agents must make sure that they accurately represent what the figures in a life insurance policy illustration mean. Agents won't get into trouble if they illustrate only guaranteed values.

No one can say how different from the illustration actual policy performance may be, or whether the difference will be favorable or unfavorable to the policyowner. If agents are going to illustrate non-guaranteed values, the best they can do is to understand the assumptions upon which the policy illustration is based, and then communicate that understanding to the prospect.

Policy illustrations are used by agents to demonstrate how the cash values and non-guaranteed elements of a proposed life insurance policy may perform over the life of the policy. While consumers may fail to read the policy and its accompanying sales literature, they will pay attention to illustrations, which use charts and graphs to demonstrate how cash values may grow over a period of time.

Consumers often do not understand that policy illustrations are estimates of what might happen based on the continuation of a given set of assumptions. Too many assume the numbers used in sales illustrations are a promise or guarantee of the policy's future performance. And although sales illustrations are traditionally accompanied by strong cautionary language indicating that numbers shown are estimates only, consumers often fail to read or understand such language.

Consumers can be led to believe that their policy will perform like an investment product, or that premiums will "vanish" after a short period (such as 10 years). Many agents have used "current" values rather than the values guaranteed by the policy.
(which are much lower) to illustrate possible future performance of a policy.

Modern technology has pushed this abuse to new levels. It is now possible for agents to sit down at their personal computers and produce their own illustrations without company review. Some agents have even gone so far as to exclude the guaranteed column of information to mislead customers.

One alternative to unreliable sales illustrations is to compare companies and policies based on actual past performance with the caveat that "past performance is no guarantee of future results".

**COST COMPARISON METHODS**

To help insureds make cost-effective selections about life insurance products, there are two basic methods that may be used to compare the cost of different policies - the traditional net cost method, and the interest-adjusted cost method.

**THE TRADITIONAL NET COST METHOD**

Under this method, premium payments for a specified number of years are added together, the projected cash value accumulation and any dividend payments for the period are then subtracted, and the result is divided by the number of years under consideration to produce an "average annual net cost." The traditional method makes a comparison without regard to the time value of money, which takes into account both the ability to earn interest and the tendency for cash value accumulations to lose relative value during inflationary periods.

**THE INTEREST-ADJUSTED COST METHOD**

Under this method, the calculation is similar except that an adjustment is made for an interest rate. For example, dividends will be assumed to earn a specified interest rate, and the future aggregate of cash value and dividends will be discounted by an interest rate when determining the "interest-adjusted average annual net cost." This method factors in the time value of money.
LIFE INSURANCE UNDERWRITING

Underwriting is the process of selection and classification of risks. The process consists of evaluating information and resources to determine if the client will be accepted or rejected and how an individual will be classified (standard or substandard). Once this part of the underwriting procedure is complete, the policy will be rated and the premium which the applicant will pay will be determined. The policy will then be issued and subsequently delivered by the agent.

An underwriter's job is to use information gathered from many sources to determine whether or not to accept a particular applicant. An underwriter will also consider perceived hazards which may appear to be present.

Acceptable applicants should be placed in the correct underwriting class and pay an appropriate premium that reflects the exposure for that class.

Life insurance underwriting is based, in part, on the basic principle of emphasizing the standard acceptable group, so that most applicants are accepted at standard rates. A large number of rejections increases the insurer's cost of doing business, erodes the morale of the sales force, and may also lead to a loss of goodwill among the buying public.

Important underwriting factors for individual life insurance include age, sex, build, physical condition, personal and family health history, smoking habits, involvement in hazardous sports or hobbies, personal habits and morals, country of residence, and occupation.

In addition to the individual pieces of information received, an underwriter must frequently exercise judgment based on his or her years of experience in order to form an overall opinion about the nature of a particular risk. An underwriter might decide to reclassify or reject a risk, or maybe simply take a closer look by ordering an investigative report, requesting a medical examination, or checking some of the facts a second time.

ADVERSE SELECTION

One of the underwriter's tasks is to protect the insurance company from the consequences of adverse selection against the insurance company. Adverse selection means that there is a greater tendency of those who have a greater risk of loss to apply for, and obtain, insurance.

Among those who voluntarily contact an insurance company or agent for the purpose of buying life insurance, it is likely that an above-average proportion of the applicants already have health problems, have a family history of premature death, or are engaged in dangerous occupations. Those most eager to buy life insurance may be motivated to do so because they are at a higher risk of premature death.

If too many poor risks are accepted, the insurance company will lose money, so it is an underwriter's job to evaluate risks, to reject uninsurable risks, and to require higher premiums for insurable substandard risks. If excessive losses lead to higher premium charges, insurance would become less affordable and fewer people would buy insurance.

LAW OF LARGE NUMBERS

To stay in business an insurance company must strive for a reasonable balance between the affordability of insurance to consumers, and having the ability to pay expected loss payments.

In order for the insurance concept to work, underwriters must rely on the Law of Large Numbers. The principle of the Law of Large Numbers is based on this premise: The greater the spread of risk, the more predictable losses become. The greater the premium base, the more affordable insurance becomes.

Without an adequate spread of risk, losses cannot be predicted. Without an adequate premium base, loss experience is likely to swing erratically. When the Law of Large Numbers applies, adverse selection is minimized and loss experience should approach broad statistical averages.

Centuries of marketing life insurance products have made consumers aware of the need for life insurance and the important role it plays in providing security.

A large number of persons insured over a long time period gives life insurers a large amount of statistical data on which to base their rates.
**LOSS AND EXPENSE RATIOS**

In order to monitor experience and adjust underwriting guidelines, insurance companies calculate loss and expense ratios. They also look at the combined ratio to determine whether they are experiencing an underwriting profit or loss. These ratios may be calculated by account (all policies written for a particular client), by line of insurance (all policies of the same type), by “book of business” (all accounts placed by each agent or agency), and for all business written by an insurer (the total for all types of insurance written by the company). Loss ratio information may be used to make decisions about whether to renew accounts, whether to continue agency contracts, and whether to tighten underwriting standards on a given line of insurance.

**Loss Ratio**

The loss ratio is determined by dividing losses by total premiums received. If an insurance company pays out $6 million in death claims under individual life insurance policies that generated $8 million in premiums for the year, its loss ratio for the year would be 75%.

**Expense Ratio**

The expense ratio is determined by dividing an insurer’s operating expenses (including commissions paid) by total premiums received. If an insurance company has total expenses of $4 million on business that produced $20 million in premiums, its expense ratio would be 20%.

**Combined Ratio**

The combined ratio is the total of the loss and expense ratio. When the combined loss and expense ratio is 100%, the insurer breaks even. If the combined ratio exceeds 100%, an underwriting loss has occurred. If the combined ratio is less than 100%, an underwriting profit, or gain, has been realized.

- If an insurance company has a combined ratio of 85% for the year, it has experienced an underwriting profit equal to 15% of the premiums written.
- If an insurance company has a combined ratio of 110% for the year, it has experienced an underwriting loss equal to 10% of the premiums written.

**SELECTION CRITERIA - UNDERWRITING FACTORS**

Life insurers use a number of important underwriting factors to determine whether applicants for life insurance are acceptable, substandard, or uninsurable. The major factors are summarized as follows:

**PERSONAL HEALTH**

The current health of an applicant is important for obvious reasons. An applicant with a serious disease, such as AIDS or cancer in the advanced stages, would have a reduced life expectancy and is probably uninsurable. An applicant with lesser diseases which can be managed, such as diabetes, may be insurable but the condition may present additional risks, which may require a higher premium rate. A combination of conditions, such as being overweight and having high blood pressure, will usually increase the underwriter’s concern. Minor conditions, even some chronic conditions such as allergies, may have no impact on life expectancy, but the underwriter still wants to know about them.

**AGE**

The mortality rate correlates with age. Generally, the older the applicant, the higher the premium.

**SEX (GENDER)**

Women have a longer life expectancy than men the same age. As a result, women typically are charged lower premiums than men.

**BUILD**

Build refers to the relationship between height, weight, and girth (the comparison of an expanded chest with the abdomen). Mortality rates are substantially higher for overweight people.

**PHYSICAL CONDITION**

Depending on the amount of life insurance desired, certain tests may be required to determine the applicant's physical condition. These tests include a blood pressure test, a urinalysis test to detect kidney disease, a blood test for AIDS, and an electrocardiogram to detect heart disease.
HEALTH HISTORY

Both the applicant's personal and family health history will be considered when evaluating the risk. An applicant who is currently healthy may have a history of past health problems, even recurring problems, which could affect the decision. An applicant who has no present or past symptoms of illness or disease may come from a family where there is a history of diseases. Certain health characteristics are hereditary. Applicants are asked questions concerning the health history of family members, such as heart disease, cancer, diabetes, and other serious disabilities.

LIFESTYLE

An applicant's lifestyle must be considered independently from the applicant's current health, family history, occupation and hobbies. This area of concern relates to personal habits and activity patterns. Behaviors like smoking, drinking alcohol, taking drugs, or exercising regularly may reveal either positive or negative lifestyle patterns.

SMOKING & TOBACCO USE

Smokers have higher mortality rates than non-smokers. Applicants are asked questions concerning whether they smoke or when they discontinued smoking. Other types of tobacco use are also related to higher mortality rates and most insurers today also request information about usage of any tobacco products.

HAZARDOUS SPORTS AND HOBBIES

In modern society, recreational activities and hobbies may present a greater risk than occupations. Some sports and hobbies are hazardous and can increase the insurer's mortality risk. These activities include sky diving, hang gliding, scuba diving, and race car driving, among others.

PERSONAL HAZARDS

In general, a hazard is something that increases the likelihood that a loss may occur. With respect to an applicant for life insurance, there are two types of possible personal hazards that an underwriter may be concerned with: moral hazards and morale hazards. These stem directly from an individual's attitudes and values.

- A moral hazard arises out of an individual's tendency to lie or be dishonest. An applicant who conceals or misrepresents information about health status, health history, or occupation on an insurance application to mislead the underwriter in order to provide insurance, or to provide it at a lower rate than should be charged.
- A morale hazard arises out of an applicant's carelessness or indifference toward taking risk. For example, an applicant with a history of indifferent or apathetic attitudes toward his or her own health and safety, and that of others, presents a morale hazard to the underwriter.

HABITS AND MORALS

Applicants are asked questions concerning the use of alcohol and drugs. However, alcoholics who have successfully undergone treatment or have not consumed alcohol for a number of years may be insurable at standard rates. Moral factors are also considered, including serious financial problems such as bankruptcy.

RESIDENCE

Mortality rates vary throughout the world due to living standards, climate, disease, sanitation, war, and other factors. Underwriters may take into consideration the fact that an applicant travels a great deal, especially in certain parts of the world.

OCCUPATION

Occupation is not as critical a concern as it once was in the days before state and federal safety standards were established for the workplace, but it still may be significant. Insurance is usually available for applicants involved in more hazardous occupations, but higher premiums are frequently charged.

Certain occupations have relatively high accident rates, while other occupations expose workers to certain types of occupational disease. Hazardous occupations include underground mining, lumber mills, construction, farming, and jobs where the workers are exposed to dust and poisons.
WHAT THE UNDERWRITER NEEDS

What the underwriter needs most is a fully completed application. If any information or signatures are missing, the underwriter might return the application (with no coverage in force) for the missing information and initials or signature of the prospect required with the added information. The application is attached to the policy and becomes a part of the contract, and complete information is essential to have a prospect's life insurance underwritten and issued quickly.

Once the policy is in force, the insurer has few rights to cancel, deny, or modify coverage, so the decision to accept coverage must be made with all the facts at hand. Producers do not have binding authority and the life policy is in force only upon delivery to and with payment from the policy owner (accurate).

Every life insurer has a guide detailing the additional information and underwriting requirements that must accompany the application.

Sources of Information

An underwriter uses several resources to provide the necessary information for completing the risk selection process. The major sources of underwriting information include:

- The insurance application
- The insurance agent
- Medical exams and history
- Inspection reports
- The Medical Information Bureau (MIB)

The Application

The application for insurance is the most important source of underwriting information. The statements on the application may prompt the underwriter to request additional types of information (such as a medical exam or inspection report). An application must always be submitted, while other sources of information are used only when deemed necessary.

The form of an application may differ from one company to another. However, most applications have places for recording general information and medical information about the proposed insured(s).

The general information section usually has spaces for writing the name and address, date of birth, occupation, and marital status of the proposed insured. It may ask for information about any high risk activities (such as racing or diving). A list of other life insurance in force is usually requested, as well as whether any prior application for insurance has been rejected or specially rated. The amount of insurance being applied for, riders to be attached, and various policy options elected will be shown in this section. Names of beneficiaries are to be shown and, if the applicant and the insured are not the same person, the name and address of the policyowner and relationship to the proposed insured must be shown.

If the amount of insurance applied for qualifies as "nonmedical" (no medical exam required), then the agent and the insured will complete the health statement or medical questions section of the application. If the applicant is required to take a medical exam, this section is usually left blank at the time of application and is completed by the doctor or paramedic at the time of examination.

The medical questionnaire or health statement asks questions about the proposed insured's height, weight, and past medical history. Many questions are to be answered on a "yes" or "no" basis only. Specific questions are usually asked about types of illnesses or conditions. Other questions ask whether any proposed insured has had a checkup, been an inpatient, or received various types of treatments during a specified period of time prior to the application. Usually, this section will ask for the ages of other living family members, causes of death and ages of any deceased family members, and for the details of any "yes" answers to the health questions.

A completed application provides a lot of information about the insurance policy requested (types and amounts of coverage, insureds and beneficiaries, and policy options), and it reveals a lot about the insured's personal and family history. The signatures of the agent and proposed insured (and the owner, if different) are required to complete an application.

The Agent

Another significant source of information for the underwriter is the insurance agent. The underwriter usually does not have personal contact with the applicant, but the agent does. In addition to assisting the applicant by completing the general and medical sections of the application, the agent is also required to complete a separate section which constitutes the agent's own report or statement.
about the insured. The agent’s statement is part of the application and it requires the agent to provide certain information regarding the proposed insured. Generally, this includes information regarding the agent’s relationship to the insured (if any), how long the agent has known the proposed insured, data about the proposed insured’s financial status, habits, general character and any other information which may be pertinent to the risk being assumed by the insurer.

This section includes a blank space for additional comments. Here the agent has an obligation to enter any information which may be important. This may include comments about anything material that the application questions failed to address. It may also include comments about any information given by the applicant which appears to be contradictory or false.

An insurance agent is legally and ethically obligated to disclose important information to the insurer. It would be illegal for an agent to withhold information due to a desire to sell the policy and receive the commission.

Medical Exams

A medical examination will more accurately reveal current health status. Medical exams are frequently not required for small amounts of insurance. For intermediate amounts of coverage, they may or may not be required. Medical exams are almost always required for large amounts of insurance. The doctor will record current height, weight and blood pressure, in addition to performing other tests (blood, urine, x-rays, etc.).

Another related source of medical information available to the underwriter is an Attending Physician's Statement or (APS). This is a report from the insured's own physician regarding the applicant's health status and history. After a review of the medical information contained in the application or revealed by a medical exam, the underwriter may request an APS from the proposed insured's doctor to provide more specific information about a particular medical problem.

Inspection Reports

Inspection reports, from independent investigating firms or credit agencies, usually cover the applicant's financial situation and moral reputation. This information may be used to help determine the insurability of the applicant by discovering moral or morale hazards. When an investigative report is prepared, the information is based on interviews with the applicant's associates at home, at work, and elsewhere.

Medical Information Bureau

Another source of information which may aid the underwriter in determining whether or not to accept a risk is the Medical Information Bureau (MIB). This is a nonprofit trade association which maintains medical information on applicants for life insurance.

MIB information is reported in code form to member companies in order to preserve the confidentiality of the contents. The report does not indicate any action taken by other insurers, nor the amount of life insurance requested. In addition, an insurer may not refuse to accept a risk based solely on the information contained in an MIB report. There must be other substantiating factors which lead an insurer to decide to deny coverage.

UNDERWRITING ACTIONS

Although the underwriting process may consist of many stages, ultimately all risks are either accepted or rejected. At the conclusion of the process, final underwriting actions fall into one of three categories:

- Reject the risk
- Accept the risk as standard
- Accept the risk on some other basis

CLASSIFICATION OF RISKS

Underwriting also involves the classification and rating of acceptable risks. Risk classification means making a determination as to whether a risk is standard or substandard based on the underwriting or risk evaluation process.

After evaluating the information provided by the applicant and other sources, several underwriting decisions are possible. First, the applicant may be rated as standard and charged the normal premium for the desired coverage. More than 90 percent of life insurance applicants are accepted at standard rates. Second, the applicant may be rated as substandard and charged a higher premium. About 6 to 7 percent of the applicants are insured at substandard rates. Finally, the applicant may be rejected. About 3 percent of the applicants are denied insurance altogether.
Standard Risks

A standard risk is simply an average acceptable risk. The vast majority of applicants fall into this classification.

Substandard Risks

A substandard risk is a risk which is acceptable, but which has some negative characteristics that suggest these risks will have an actual mortality experience which is higher than normal. Most insurers use one or more rating plans or methods to develop the higher rates that must be charged for applicants who are not acceptable at standard rates, sometimes called "extra risk" or "substandard."

For substandard risks, an additional premium must be charged. Common techniques for developing an additional premium are to rate the risk at a higher age, apply a flat additional amount, apply a percentage increase, or to apply graded benefits which are initially lower than the premium charge would otherwise suggest. In some cases, a premium credit or discount may be offered to a preferred (above standard) risk.

One approach is known as rated-up age, which simply means that the premium is based on an age which is greater than the insured's actual age. While this method simple to handle, it is not very scientific and depends heavily on judgment.

Another approach is to charge a flat additional premium for the element of extra mortality. This charge is a constant dollar amount that does not vary with age. This constant amount is added to the standard premium, which is based on standard rates and the insured's attained age.

Higher premiums may also be obtained by charging a percentage increase, instead of a flat dollar amount. Under a method known as tabular rating, applicants are classified on the basis of the extent to which mortality for their class of risk exceeds that of the "standard" risk. Extra percentage table is usually designated as "Table A," "Table B," etc. Each usually reflects about a 25% increase above 100%, or "standard." Insurers vary in the number of tables on which they will accept risks.

Under another method known as graded death benefits, the insured pays the standard premium for insurance but receives a policy with a face amount lower than the premium would pay at his age. After some time has elapsed the company may increase the amount of insurance periodically and when the company considers the substandard condition to no longer exist, the full amount of coverage would be granted.

Preferred Risks

In addition, some applicants qualify as a preferred risk. Life insurance is provided at reduced rates to individuals whose mortality experience is expected to be lower than average. Often, a minimum amount of life insurance must also be purchased. Sometimes certain coverage features and enhancements are only available to applicants that qualify as preferred risks.

A preferred risk is one that presents a below average risk of loss - mortality experience for this group is expected to be better than average. Applicants who may be eligible for preferred risk classification and rates are those who work in low risk occupations and do not participate in high risk hobbies, who have a very favorable medical history, who are presently in good physical condition without any serious medical problems, who do not smoke, and who meet certain weight limitations.
GROUP LIFE INSURANCE

In addition to individual life insurance, group life insurance is also important in providing financial security to families. Today group life insurance accounts for almost half of the total amount of life insurance in force in the United States.

Group life insurance differs from individual life insurance in several respects. Many individuals can be insured under a master contract between the insurer and policyowner; experience rating is used in larger groups to determine the premiums charged; individual evidence of insurability is usually not required because group underwriters evaluate the overall characteristics of the group; and the coverage usually provides low-cost protection to the employee.

Most states have enacted standard provisions for group policies, including:

- **Grace period** (usually 31 days)
- **Incontestability** (usually one or two years after the policy becomes effective; usually two years from the insured's effective date of coverage)
- **Entire contract** (the application must be attached to and made part of the contract)
- **Evidence of insurability** (individual insurability must be proven if the employee or member joins the plan after the enrollment period)
- **Misstatement of age** (premium is adjusted to the correct age; under individual insurance benefits are adjusted)
- **Facility of payment** (allows payment of policy proceeds to a close relative or friend if no beneficiary is named or living)
- **Conversion** (the right to convert to an individual policy when the insured's coverage is terminated or the master policy is terminated)
- **Individual certificates** (issued as evidence of coverage)

A group master policy is issued to the policyholder, and individual certificates (evidences of coverage under the group master policy) are issued to all enrolled employees or members.

**BASIC CHARACTERISTICS**

Group life insurance is frequently issued to employers, labor unions, trusts or associations to cover employees or members. The plan sponsor (the employer, union, association, etc.) is the policyholder responsible for administering the plan and making premium payments to the insurance company. Coverage is generally available without individual medical examinations. Premiums are based on the experience of the group as a whole.

Group life insurance has certain basic characteristics:

- Numerous individuals are insured under a master contract, which contains all of the provisions concerning the coverage provided. There are only two parties to the master contract: the insurer and policyowner. In most cases, the group policyowner is the employer. Each individual insured receives a certificate of insurance, which provides evidence of coverage.
- Individual members are not normally required to provide evidence of insurability. Group insurance underwriters evaluate the overall characteristics of the group of persons to be insured rather than the individual characteristics of each person in the group.
- If the group is sufficiently large, experience rating is used to determine premiums. Under experience rating, past losses sustained by the group are considered in determining the policy premium.
- For covered employees the cost of group life insurance is generally lower than individual coverage because the employer may pay part or all of the cost, which reduces the cost to the employees.

**GROUP UNDERWRITING FACTORS**

Based on state law and insurer practices, most groups today are eligible for group life insurance. However, before a group can be covered, insurers consider certain underwriting factors to determine whether the group is acceptable.

- The group must not be formed solely for the purpose of purchasing insurance. This requirement protects the insurer against the possibility of a substandard group being formed solely to obtain insurance.
Ideally there should be a moderate turnover of persons in the group. Groups with high turnover will increase the administrative expenses under the plan. However, groups with low turnover will increase the average age of the group, which might result in higher premiums.

The size of the group is an important underwriting factor. If the group is large, prior group loss experience rating can be used to determine the premium.

**Small Groups**

Smaller groups are less desirable from an underwriting viewpoint. A small group presents two important problems: (1) administrative expenses tend to be relatively higher than for large groups and (2) adverse selection is more prevalent. To deal with these problems, the insurer’s underwriting practices might be more restrictive for small groups, such as less liberal contractual provisions and individual underwriting in some cases.

**Contributory vs. Noncontributory Groups**

In addition, minimum participation requirements are important in group underwriting. A minimum percentage of eligible group employees must participate in the plan.

In group insurance, a noncontributory plan is one for which the employer pays the entire cost. If the plan is noncontributory, most insurers and many state laws require coverage of 100 percent of the eligible employees.

A contributory plan is a plan for which employees pay part or all of the insurance cost. If the plan is contributory, a lower percentage of employees is required, such as 75 percent. A minimum participation requirement helps to protect the insurer against adverse selection.

**Other Factors**

Finally, some additional factors are considered in group underwriting. These include efficient administration, such as payroll deduction by employers; prior loss experience of the group; age and sex composition of the group; and occupational hazards in the industry that the group represents.

**ELIGIBILITY REQUIREMENTS**

Employees must meet certain eligibility requirements before the coverage becomes effective:

- The employer may limit coverage to only full-time employees. The employer determines the number of hours for full-time employment, which must be at least 20-30 hours weekly. However, depending on insurer practices, part-time employees may also be covered.
- In some group plans, new employees must satisfy a probationary period, which is a short waiting period of one to six months, before they can participate in the plan. The purpose of the probationary period is to eliminate coverage of transient workers.
- New employees must sign up for the insurance either before or during their eligibility period. The eligibility period is typically a thirty-one day period during which the employee can sign up for the insurance with no evidence of insurability. If the employee requests coverage after the eligibility period expires, the insurer usually requires evidence of insurability to protect against adverse selection.
- Before the coverage becomes effective, the employee must be actively at work. If the employee is absent from work because of sickness or injury, coverage begins when the employee returns to work.

**GROUP LIFE INSURANCE BENEFITS**

Most group life insurance plans provide yearly renewable term insurance to the members. The amount of insurance can be based on the employee’s earnings, position, or length of service, or it can be a flat amount for all. Most group term insurance plans provide an amount of insurance equal to some multiple of the employee’s annual earnings, such as one or two times annual earnings. If employment is terminated, the employee has the right to convert the term insurance to an individual policy within thirty-one days with no evidence of insurability.

Some group life insurance plans also provide accidental death and dismemberment benefits that pay additional benefits if the employee dies in an accident or incurs certain types of injuries.
**Dependent Coverage**

Many group plans also offer dependent life insurance, providing modest amounts of life insurance on the lives of the employee's dependents. Dependents include the insured's spouse, children, dependent parents, or any person for whom dependency can be proven. Children may be stepchildren, foster children, or adopted children. Dependent children must be under a specified age (such as 19) which may be raised to age 21 or 22 if attending school full time.

**Conversion Privilege**

Group life insurance policies must include a conversion privilege that gives insured members the right to convert to an individual policy upon termination of the master policy, or the loss of group coverage due to termination of employment or loss of eligibility on the part of a class of insureds. Generally, anyone whose coverage terminates has 31 days in which to exercise the conversion privilege. If an individual dies after the group coverage has terminated and before the end of the 31-day conversion period, the group coverage is still in effect and the specified death benefit will be paid under the group policy.
SALES PRESENTATIONS

Insurance applications and receipts are a part of the insurance sales process. Life insurance sale presentations usually begin with information gathering, a needs analysis, and a review of the applicant's existing life insurance coverages. Once needs and goals are clear, and the unmet insurance need has been brought into focus, the agent will usually make a sales proposal which consists of one or more specific recommendations.

Life insurance sales do not occur in a vacuum. Rarely does an applicant step forward and request a specific type of policy and specific amount of insurance. Rarely would an insurance agent proceed with an application on the basis of such a request without further discussion about the applicant's situation, insurance needs, and existing insurance coverages. In most cases, life insurance must be sold to an applicant, often depending upon making a convincing sales proposal.

There are two reasons why an agent should not hastily conclude a life insurance sale without exploring the applicant's overall needs and current insurance status:

- An agent has a duty to act in the best interests of the applicant and to recommend appropriate types and amounts of coverage.
- Sales opportunities could be lost if an agent fails to fully explore and expose an applicant's unmet insurance need.

Sales presentations are sometimes concluded in a single session, but successful presentations frequently consist of at least two separate sessions. Generally, the first session is exploratory in nature. The agent asks probing questions and has an opportunity to assist in determining the applicant's actual insurance needs and goals. Once the overall insurance need has been clarified, it is extremely important to review an applicant's existing insurance coverages.

The information gathered will help the agent to analyze the situation. The agent will try to determine the applicant's immediate vs. long-term need for insurance, how much the applicant can afford to pay (or is willing to pay) for insurance, how much the applicant is currently paying for insurance, and how appropriate existing coverages are in satisfying the applicant's overall needs.

The sales proposal itself is usually made in a subsequent session, after the agent has taken some time to analyze all of this information and to prepare alternative recommendations. The primary proposal should focus on the applicant's general unmet needs with a realistic balance between cost, benefits, and affordability.

Formal proposals consisting of typewritten comparisons of alternatives or computer printouts are usually more effective than hand written proposals, because they are neater and appear much more professional. Once a specific proposal is accepted by a proposed buyer, the insurance application process begins.

The Life Insurance Application

When an application is taken, the agent is responsible for making sure that all questions are answered completely and accurately. Applications contain information about the policy being applied for, existing insurance, and the applicant's personal health history and family history. Much of this information is used in the underwriting process and the application itself usually is attached to, and becomes a part of the actual insurance policy itself.

Three Parties to an Application

A life insurance application contains three parties:

- The proposed insured.
- The applicant.
- The policyowner.

THE PROPOSED INSURED

The person whose life is being insured by the life insurance policy.

THE APPLICANT

The person that is making application to the insurance company for the life insurance and may or may not be the proposed insured.

THE POLICYOWNER
The person that usually pays the premiums and the person who retains all rights to any values or options contained in the policy.

**Definition of an Application**

In order for a person to purchase life insurance they must make a request to the insurance company of their choice. The form on which this request is made is known as an application.

Most companies now require that the proposed insured be physically present in front of the agent while the questions on the application are being filled out. The application is crucial in that it provides the data that the underwriters and insurance company will use to determine if a policy will be issued.

When the proposed insured signs the application he is making a formal request to the company that a policy be issued on his life. In addition, the signature on the application indicates that the information is true and correct to the best of his knowledge.

**Applications for Life Insurance on a Minor**

In most states a person is not considered an adult until 18 years of age. As a rule, minors are not permitted to enter into contracts. However life insurance is the exception in that a person is a minor only until age 15. In the event that the proposed insured is younger than age 15 one of the following persons must sign the application on behalf of that child:

- The mother or father of the minor child.
- A court appointed safeguard for the well-being of the minor.
- The grandparents of the minor child.

**Correcting Applications**

Should it be necessary to correct a mistake regarding information given on the application, the proposed insured must initial any and all changes on that application.

Mistakes on the application can be costly, especially when the company is paying an outside reporting service to conduct an inspection. Any changes that are made on a completed application must have the approval of the proposed insured. The normal procedure is to return the incorrect application to the agent who in turn will take it to the insured to have the errors initialed.

**Incorrect/Incomplete Applications**

Should an application contain incorrect or incomplete information it should not be taken lightly. In the event that the company has already made a decision on a risk, based on these inaccuracies, it could result in a serious loss.

Should the error be discovered after the issuance of a policy the company can cancel or rescind the entire contract from the date of issue. Of course this must take place before the incontestability clause of the contract takes effect.

**Representations/Warranties**

All statements on applications are regarded as representations. When an individual makes a statement he believes to be true, he is making a representation of the truth. While it is possible that a representation may be found to be untrue, a person who makes a representation believes it to be true.

A warranty on the other hand is a statement made with such absolute certainty that it is guaranteed to be true. No statement on an application is considered a warranty.

**Misrepresentation - A false representation can be defined as a misrepresentation.**

**Fraud**

There are three elements necessary to constitute fraud:

- A person makes an intentional misrepresentation of what is known to be a material fact.
- The person has intent to gain advantage.
- A person relies upon a second party that suffers a loss.

There can be no fraud unless there is intent.
Concealment

Concealment is close to misrepresentation when it comes to information included on a policy application.

While misrepresentation, as stated earlier, is something known to be untrue, concealment is withholding of facts that the applicant should have given to the insurance carrier at the time of application.

Conditional Receipt

Always collect the first full premium from the applicant at the time of application. The receipt that is located at the bottom of the application is called a conditional receipt. The word "conditional" is very important because the agent is not guaranteeing that the policy will be issued. Issuance of the policy is subject to the full approval of the insurance carrier.

The conditional receipt serves two functions:

- It acknowledges the first full premium.
- It states in very clear terms that the policy acceptance is subject to the approval of the carrier.

Should the Insured Die

In the event the proposed insured dies before the policy is issued, according to the conditional receipt, the following will take place:

- If the insurance carrier would have issued the policy to the proposed insured, had they still been living, then the proceeds would be paid to the beneficiary.
- Should the above not be the case and the claim is denied the premium will be returned to the beneficiary.

Policy Effective Date

Full protection takes effect as of the policy effective date. The policy effective date also begins the date on which the contestable period begins to run. The policy effective date also is the date on which the suicide clause begins to run.

There are three reasons why the policy effective date is important:

- Insurance begins on this date.
- The contestable period begins on this date.
- The suicide clause begins on this date.

INFORMATION PRACTICES

As part of the application process, an agent may be required to provide to the applicant a Notice of Insurance Information Practices. Specific requirements vary by state, but state laws are generally based on two federal laws, the Fair Credit Reporting Act and the Privacy Act. Generally, these laws regulate the use and disclosure of insurance information, specify the types of information that may be included in investigative reports, prohibit certain types of information, establish procedures under which consumers may gain access to and challenge inaccurate information, and impose penalties for violations of permitted information practices. Since federal law sets minimum requirements, where specific state laws have been passed they are often more stringent in some areas than federal law.

Notices are also usually required in connection with policy reinstatements or requests for increases in benefits. These notices typically explain the types of information to be collected, the sources used for gathering information, the parties who will have access to the information, and persons to whom the information might be disclosed without the applicant's prior authorization. Recent privacy legislation contained in HIPAA imposes further responsibilities on agents when dealing with private information of clients.

In cases where specific investigative reports are prepared or information is to be obtained through interviews with persons other than the applicant, a specific notice must be given at the time information gathering begins - this is usually mailed by the insurance company. Other notices may be required to be provided when a policy is delivered by the agent.

Information Disclosure Authorization Forms are frequently included in, or are used in conjunction with, insurance applications. These forms are signed by the applicant and authorize physicians, hospitals, or other medical practitioners to release medical information about the proposed insured to the insurance company. The forms also explain that the information is generally confidential, but may be released to certain parties, such as the Medical Information Bureau, any reinsurance
companies involved, and any other insurance company to which a claim has been submitted concerning the applicant's life or health.

An applicant's signature on a disclosure authorization form is usually effective for a limited period of time (typically two or three years). After this period expires, the insurer would have to obtain a new authorization before it could engage in such information gathering practices. Once a policy has been issued, subsequent needs for information gathering are usually triggered by a specific event - such as a policy lapse and reinstatement, a request for increased benefits, or a claim.

The privacy and information practice laws are designed to protect consumers against the improper use of information, and from the negative consequences of incorrect information. If a person's application for insurance is turned down on the basis of the information contained in an investigative report, that person has the right of access to the information, a right to know to whom it was distributed, and a right to challenge the information and request that a correction be made.

**REPLACEMENT TRANSACTIONS**

Replacement of life insurance refers to any sales transaction involving the purchase of new life insurance which replaces existing life insurance. Any new sales transaction in which existing insurance is to be surrendered, lapsed, terminated, or reissued with a reduction in benefits or cash value is considered to be a replacement transaction.

Replacement transactions are not prohibited, but they are highly regulated because of the potential for abuse. Replacing existing insurance may be disadvantageous to the insured because an older policy may have more favorable policy loan interest rates, incontestability and suicide clauses may have expired, the proposed insured must prove to be currently insurable, and the premium for a new policy will be based on the higher mortality cost associated with the insured's current attained age. In the past, unscrupulous agents have persuaded consumers to give up old policies for new ones, even when it was not in the best interests of the policyholder, largely because the front-end commissions paid to agents for selling new policies are particularly lucrative. This is why replacement transactions are carefully regulated.

However, there may be legitimate reasons for replacing an existing policy. A policy may be inappropriate for an insured's current needs. It may have originally been misrepresented, or it may be the wrong type to satisfy a particular financial plan, or the cost may be excessive, which results in the insured being seriously underinsured from purchasing an inadequate amount of coverage. In such cases, the premiums being paid for existing policies might be put to better use, and it might be more appropriate to apply existing cash values as deposits towards other insurance or investment plans.

The most important thing to remember is that any recommendations for replacement be based on the best interests of the insured, and not principally on the desire of an agent to make a sale. It is vitally important that the prospective insured fully understands how the costs and benefits of the proposed and existing insurance policies compare, and that the agent complies with state laws regarding notice, disclosure and reporting of replacement transactions.

In most states, an agent has certain legal duties when new life insurance is to be purchased and it is known, or should reasonably be known, by the agent that replacement of existing life insurance is involved as part of the transaction. Agents are supposed to obtain, along with an application for life insurance, a signed statement from each applicant as to whether or not existing insurance is to be replaced. If replacement is involved, the agent is usually required to make a list of all existing life insurance policies to be replaced. This list must be submitted to the insurance company proposing to issue the replacement policies. Additionally, the agent is required to give the applicant a Notice Regarding Replacement of life insurance. Frequently, the signatures of both the agent and applicant are required on the notice. This notice cautions the applicant about the risks involved and urges the applicant to compare the policies and any outlines of coverage very carefully.

Copies of the notice, list of policies to be replaced, and other documents related to the transaction must be submitted by the agent to the insurance company. In many states, the replacing insurer is required to forward a written notice of replacement along with other documents and policy summaries to the existing insurer within a minimum number of days. This gives the existing insurer an opportunity to challenge the transaction by attempting to conserve its policies (keep them in effect). The
conserving actions are also subject to strict rules regarding disclosure and honesty.

**AGENT'S COLLECTION OF PREMIUM**

It is a good idea to collect the initial premium with the application because it demonstrates a greater commitment to the sale, reduces the chances that the policy might not be accepted, and could protect the proposed insured if death or insurability occurs between the date the application is signed and the date the policy is actually issued.

Life insurance coverage never takes effect until the initial premium has been paid. If the applicant dies before the policy is issued and actually accepted by payment of the premium, there will be no insurance coverage. This unnecessary risk can be eliminated by payment of the premium with the application.

**OFFER AND ACCEPTANCE**

An insurance policy is a legal contract, and in order for a contract to exist there must be an offer and acceptance of that offer, as well as an exchange of consideration between the parties. In a life insurance transaction, either party can initiate the offer, but who actually makes the offer depends upon the circumstances.

When the initial premium is paid with the application, the applicant has made an offer. If the insurance company issues the policy, it has accepted the offer. At this point a contract exists and, if the insured died before the policy was actually delivered, a death claim would be payable.

When the initial premium is not paid with the application, no contract is in force, even if the application is acceptable to the underwriter. The applicant has not made a legal offer to the insurance company. The applicant has merely invited the insurer to make an offer by issuing the policy. If the company issues the policy, it has initiated the offer. But a contract does not yet exist, because the offer is not accepted until the applicant pays the premium and takes delivery of the policy. This is why there would be no insurance if an applicant who has not paid the premium dies before the policy is delivered.

**FIDUCIARY DUTIES**

All premium funds received by an insurance agent from an applicant or insured, and all return premiums received by an agent from an insurance company, are received in a fiduciary capacity and must be held as such. It is illegal to mix these funds with other funds, or to divert them to personal use. Usually these funds must be paid promptly to the insured or insurance company entitled to them. In some states, if premium funds are not paid immediately to the party entitled, they must be deposited in an account which is separate from all other agency and personal funds (a trust account). However, it is not necessary to establish a separate account for each insured, as long as the amounts payable to or on behalf of each can be determined from the agent's accounting records. In some cases, if the agent holds the funds for a certain length of time (10-30 days), the agent must pay interest on the funds as well to the party who the funds actually belong.

**USE OF RECEIPTS**

Usually, coverage is not effective until the policy has been delivered and the initial premium has been paid. However, when the applicant has paid the initial premium with the application, coverage may take effect retroactively back to an earlier date. In some cases, a period of coverage may apply even if the application is rejected by the insurance company. Whether coverage applies and when that coverage takes effect and terminates depends upon the type of receipt issued to the applicant.

**Conditional Receipt**

Agents most commonly issue a conditional receipt when an applicant pays the initial premium at the time of the application. This type of receipt makes coverage effective on the date of the application, if the applicant is found to be insurable as a standard risk under the company's general underwriting rules in effect at the time of application. Some conditional receipts make coverage effective the date of the application or the date of the medical examination, whichever is later.

Under a conditional receipt, coverage will begin on the application date if the proposed insured is later found to be insurable as a standard risk and the policy is issued as applied for. Under a binding receipt, coverage begins on the application date whether or not the proposed insured is insurable, and will continue for a specified period of time even
if the application is rejected and the policy is never issued.

If an applicant is acceptable but is found to be a substandard risk requiring a higher premium, then the conditional receipt is null and void and no coverage would be effective. The original offer of the applicant is rejected and issuance of a substandard policy becomes a counteroffer by the insurance company. This coverage would not take effect until the substandard policy is delivered to the applicant and accepted by payment of the additional premium required.

Another possibility is that the applicant could become sick and uninsurable before the policy is delivered. When the premium has not been paid in advance, many companies require the insured to sign a health statement at the time of policy delivery, verifying that no change in health status has occurred since the date of the application. If health has deteriorated, the agent would not be permitted to deliver the policy and there would be no insurance coverage.

**Binding Receipt**

A less frequently used type of receipt is known as an "unconditional" or binding receipt. This makes the insurance company liable for the risk from the date of application for insurance. This coverage lasts for a specified period of time, or until the insurer either issues a policy or declines the application, whichever is earlier. The specified time limit is usually 30 to 60 days.

Unlike a conditional receipt, under which retroactive coverage is contingent upon acceptance of the risk, coverage under a binding receipt always takes effect on the application date regardless of the applicant's insurability. The applicant may not be acceptable as a standard risk, or the applicant may not be insurable at all. Nonetheless, with a binding receipt he or she is covered for the specified number of days following completion of the application and payment of the initial premium.

**SUBMITTING APPLICATIONS**

It is important for an agent to submit the application, initial premium, and any questionnaires, notices, statements, or other forms required to the home office underwriter promptly. The agent should review all forms for completeness and be sure that they are properly signed. Unnecessary delays in delivering the policy can cause the applicant undue anxiety and result in a loss of confidence in the agent. Since agents are handling money belonging to their clients, it is important to keep an accurate record of each transaction. It is also wise for an agent to keep copies of applications and related documents in order to avoid unnecessary delays or other problems if the originals are lost.

**POLICY DELIVERY**

In most cases, a life insurance policy will be issued as applied for. In some cases, the coverage will be issued as applied for, but the rate and premium will be higher because the risk was classified as substandard. In rare cases, a modified or amended policy will be issued, such as when a waiver is attached to exclude death by a specific cause this might occur if the applicant has a particularly hazardous occupation or hobby.

Since policy delivery is necessary to complete the life insurance transaction, the best way to assure delivery is to do it in person. In addition to knowing the policy has been delivered, this method also gives the agent an opportunity to thoroughly explain all coverage provisions, exclusions, and riders to the applicant or policyowner. It will be especially important to explain any features of the policy which are different from the policy applied for. Personal contact at the time of delivery also gives the agent an opportunity to reinforce the relationship of good will developed during the sales presentation, and to ask for referrals now that a successful transaction has been completed.
PREMIUM COMPONENTS

Whole life policy premiums include the standard premium elements a charge for the mortality cost of the insurance, a loading for expenses such as commissions and overhead expenses, and an interest discount factor resulting from application of the level premium concept. These are the basic components of any life insurance premium charge for the protection.

However, with whole life policies is also an element of cash value or savings, and a charge is made for this. The amount of the charge for each $1,000 of face value depends upon the age at which the policy goes into effect. Each policy is designed to mature at age 100, so the amount of time available is a major factor in determining how much must be set aside to grow at the guaranteed interest rate if the target is to be reached.

Mortality is not the only premium component, although it may be the most significant variable for life insurance. In the case of the death benefits, nothing has a greater relationship to the benefit payments than mortality; however other elements contribute to life insurance rates and premiums. The three major components of a life insurance premium rate are:

- Mortality cost
- Interest
- Expenses

The final rate charged to a policyholder equals the mortality cost discounted for interest, plus the added expense loading.

MORTALITY COST

The pricing of life insurance, especially the pure protection element provided by any policy, is based primarily on the probability of when the applicant or insured will die. This probability or chance of death is known as the "mortality risk." Out of any large pool of applicants, the insurance company must receive enough premium dollars to cover the projected amount that will be paid out in death claims.

The process begins by accumulating statistics about deaths among the general population. These statistics are gathered on a nationwide basis for a number of years. It is then tabulated according to total numbers of persons at each age, and the number of deaths occurring within each age group, compared with the total number of persons in the group.

Mortality rates are reported on the basis of deaths per 1,000 persons and life insurance rates apply per $1,000 of insurance, so the mortality rate is the average mortality cost when it is turned into dollars and cents.

Rates Increase with Age

One of the reasons why it is advantageous to purchase life insurance at an early age is that the insured can "lock in" a much lower premium rate (depending on the type of coverage).

A fundamental principle of life insurance pricing is that the chance of death, and therefore the mortality cost, increases with age. Generally, mortality tables confirm this general trend, but there are two exceptions to the pattern that are worth noting:

- Infant mortality rates are higher than the rates for older children and young adults. The rate during the first year of life is very high, and then it plunges dramatically. For both males and females, the rate does not reach such a high level again until after age 40.
- The mortality rate for males rises rapidly at ages 15 through 18, and remains high through age 21. After that, it actually falls each year through age 28, after which it begins to rise annually for the remainder of life. The rates for males ages 18 to 22 are actually higher than the rates for males ages 28 to 32. This has much more to do with social trends than normal longevity - young males tend to take more risks and may be exposed to more risks than members of the general population. A disproportionate number of young males die in automobile accidents or become victims of violent acts. This trend is significant enough to be reflected in life insurance mortality tables.

At this point, we are not talking about a complete rate. The mortality cost is merely the total cost for the pure protection element of a life insurance policy. Other forces may reduce the mortality cost and add to the total policy cost.

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INTEREST

Premiums are paid in advance, which means the insurance company can use the money, and has time to invest the money and earn interest, before it needs to pay benefits. This interest is applied to reduce the mortality cost as a discount in the insurance rate calculation.

The basic cost for life insurance protection, the cost of mortality, is therefore reduced (offset) by the amount of interest applied. The mortality cost discounted for interest, without any other expense adjustment, is sometimes referred to as a “net premium” rate.

EXPENSES

Insurers incur many types of additional costs which must be reflected in the rate and passed on to policyholders. For this reason, an expense loading is added to the net premium rate. The expense loading consists of a variety of items.

One of the most significant items is the initial charge for acquisition costs - all costs in connection with putting the policy on the books. Acquisition costs are recorded as immediately incurred by the accounting department. In most cases, these costs are so high that they must be amortized over a period of years. One of the highest acquisition costs is the agent's first year commission. A policy that lapses during the first few years often creates a loss for the insurer, because it has not yet recovered its acquisition costs.

Another important part of the expense loading is the charge for general overhead expenses - managerial and clerical salaries, furniture, fixtures, rent, supplies, and all of the other general operating costs of running a business. All business enterprises have overhead expenses, which must be averaged and included in the charges for its goods or services.

It is reasonable for a company to add some percentage for expected profit (actual results may be more or less favorable). Companies also need to establish some type of contingency fund for emergencies and unforeseen events.

When an average loading for all of these expenses are added to the net rate, we have the "gross premium" rate - the amount the policyowner actually pays for the policy on an annual basis. It is equal to the mortality cost discounted for interest, plus the added expense loading.

LEVEL PREMIUM CONCEPT

Although the mortality cost increases each year, many policies are sold under the level premium plan. In order to compensate for growing mortality costs in later years, premiums charged during the early years exceed the amounts needed to cover the initial mortality cost. This excess premium plus the interest it earns is applied to offset the higher cost in later years.

Level premium policies were developed because the mortality cost accelerates rapidly after middle age. If based on actual attained age, the premiums paid at age 45 would have to double by age 55, and to increase four- or five-fold by age 65. This increasing strain on family budgets might make insurance unaffordable at precisely the time when it may be needed most. It could also force many insureds to allow their policies to lapse or to cash in their policies prematurely.

Mathematically, the level premiums paid by the policyowner (plus accumulated interest) will be equal to the amounts that would have been charged if the insurer collected increasing annual premiums to cover the growing risk of mortality. However, level premiums are usually easier on the insured's budget. Many policyholders prefer to pay the same amount for insurance each year, even if they are paying a little bit more during the early years.

The level premium concept may be applied to both term and permanent insurance. The annual premium for a 10-year level term policy is level during the policy term. The same concept of overcharges during the early years to fund growing mortality in later years applies. However, if the policy is renewed at the end of the term, the premium will jump to a new level at that time based on the insured's current attained age.
ANNUITIES

An annuity is a contract between an individual and an insurance company. The annuitant agrees to pay the insurance company a single payment or a series of payments, and the insurance company agrees to pay the annuitant an income, starting immediately or at a later date, for a specified time period. Under current tax law, money put into an annuity grows on a tax-deferred basis until the annuitant begins receiving his accumulated fund as an income. That means that one hundred percent of earnings are reinvested in an annuity and allowed to compound without having to pay taxes on earnings.

Once there was only one type of annuity. The sole function of an annuity was to convert a lump sum of money into a stream of income that was guaranteed to last for life. Today there are many types of annuities. Each type of annuity is designed to meet a particular financial concern, situation or need.

Under an annuity contract, an insurance company converts a given sum of money into a series of periodic income payments that are calculated actuarially and guaranteed to extend for a certain number of years or for the duration of an individual's life. This is the foundation upon which all annuity products exist.

Like life insurance, annuities rely on the law of large numbers as well as mortality and investment experience. Like life insurance, annuities protect against the loss of income. However, unlike life insurance, an annuity focuses not on how soon a person will die but on how long that person will live. Annuity payments protect against the risk that a person will live too long and outlast his or her income.

To properly evaluate annuities and make appropriate product recommendations, the agent must understand that all annuities are long-term planning products suitable only for clients with long-term investment horizons, such as retirement. With few if any exceptions, they are not appropriate for short-term needs or objectives.

Annuities are the only investment vehicles that can guarantee investors that they will not outlive their income, and they do this in a tax-favored manner. In addition, annuities are available with a host of differing features to meet a wide variety of investor needs.

PRODUCT HISTORY

The first modern annuity was sold in 1973. Annuity products have experienced incredible growth over the past two decades. This growth came initially from the fixed annuity business; however, in the mid-1990s, the variable annuity business really took off. According to the American Council of Life Insurance, total annuity sales were $6.3 billion in 1980, $58.5 billion in 1991, $100 billion in 1995 and more than $125 billion in 1999 and $168 billion in 2002. Today, annuity premiums account for roughly one-third of total income insurance companies receive.

LIMRA, an independent service that tracks the insurance industry, reported that fixed and variable annuity sales amounted to $98.5 billion in 1995. By 1999, that figure had ballooned to $155 billion.

The significant growth in annuities during the mid- to late 1980s was, in part, an outcome of improved product design, but primarily from expanded distribution. In addition to stockbrokers and insurance agents, two new distribution systems emerged: NASD broker-dealers and banks. This helped pave the way for a wider consumer awareness and acceptance of the annuity product.

Annuities are extraordinarily popular in modern times, but they're not new. In fact, annuities can actually trace their origins back to Roman times. Contracts were known as annua, or "annual stipends" in Latin. Back then, Roman citizens would make a one-time payment to the annua, in exchange for lifetime payments made once a year.

During the 17th century, annuities were used as fundraising vehicles. In Europe, governments would then create a tontine, promising to pay for an extended period of time if citizens would purchase shares today.

Annuities made their first mark in America during the 18th century. In 1759, a company in Pennsylvania was formed to benefit Presbyterian ministers and their families. It wasn't until 1912 that Americans could buy annuities outside of a group.

Annuity growth from that point on was steady, but annuities really started to catch on in the late 1930s. In the midst of the Great Depression, insurance companies were seen as stable financial institutions.
In 1952, the first variable annuity was created. Variable annuities credited interest based on the performance of separate accounts inside the annuity. Variable annuity owners could choose what type of accounts they wanted to use, and often received faster growth in exchange for greater risks they assumed.

**THE ANNUITY YESTERDAY AND TODAY**

Over the past 25-30 years, the annuity has changed dramatically. Investment philosophies, distribution, marketing and product design all have grown with the expansion of the market. The annuity remains one of the only tax-deferred methods of accumulating long-term retirement assets.

The historical definition of the annuity was to provide an income stream guaranteed for life. It is used today in a wide variety of financial planning applications to both accumulate and distribute assets earmarked for the long term.

Deferred annuities, with emphasis on tax deferral and asset growth, shifted the use from an income vehicle to an accumulation vehicle. Most of the innovative product designs that emerged in the 1980’s and 90’s applied to deferred annuities. Many deferred annuities were designed on the assumption that buyers would surrender or exchange the products for their accumulated value instead of annuitizing.

Since their beginning, the design of annuity products has continued to evolve. Agents and consumers have a great amount of choice when it comes to selecting an annuity. The market has evolved into these three primary categories:

**Fixed Annuities**

- Earnings come from Insurers investments which are very conservative but low-yield
- Guarantees minimum interest rates for the policy duration
- High level of safety but may not keep up with inflation
- Principal is not subject to loss

**Equity Indexed Annuities**

- Earnings are based on changes in a major market index (i.e. S&P 500®)
- Guarantee minimum interest rates for the policy duration
- Principal is not subject to loss

**Variable Annuities**

- Earnings are based on performance of investment subaccounts
- Designed to cope with inflation
- Principal is subject to loss

Each of these will be described in greater detail later in the course.
MARKET OVERVIEW

Over the last decade and a half, a number of research studies have been undertaken to better understand the dynamics of the annuity market. The income and asset distribution of families in America shown below indicates that approximately 92 percent have earned incomes of less than $100,000; it is that group that constitutes the bulk of non-qualified annuity buyers.

<table>
<thead>
<tr>
<th>Household Income &amp; Assets</th>
<th>Percentage Distribution</th>
<th>Distribution by Number of Households (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>INCOME</td>
</tr>
<tr>
<td>Under $75,000</td>
<td>83.8</td>
<td>85.9</td>
</tr>
<tr>
<td>$75,000 – 99,999</td>
<td>7.7</td>
<td>7.9</td>
</tr>
<tr>
<td>$100,000 – 199,999</td>
<td>6.2</td>
<td>6.3</td>
</tr>
<tr>
<td>$200,000 and over</td>
<td>2.3</td>
<td>2.4</td>
</tr>
<tr>
<td></td>
<td></td>
<td>FINANCIAL ASSET LEVEL</td>
</tr>
<tr>
<td>Under $250,000</td>
<td>90.1</td>
<td>92.4</td>
</tr>
<tr>
<td>$250,000 – 499,999</td>
<td>5.2</td>
<td>5.3</td>
</tr>
<tr>
<td>$500,000 – 999,999</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>$1 – 4.9 million</td>
<td>1.9</td>
<td>1.9</td>
</tr>
<tr>
<td>$5 million and over</td>
<td>0.2</td>
<td>0.2</td>
</tr>
</tbody>
</table>

In addition, studies indicate that almost one-half of these non-qualified annuity buyers are or were retired business owners, corporate officers or professionals, while fewer than 20 percent were blue collar or service employees.

With respect to the ages of non-qualified annuity owners, studies indicate that a substantial percentage—30 percent by some estimates—are age 72 and older. There are certain buying differences that were observed between individuals that owned declared-rate annuities and those that owned variable annuities or equity-indexed annuities. The first fixed annuity contract was purchased by individuals younger than age 50 in about 41 percent of contract owners. However, buyers of variable annuity contracts tended to buy at a somewhat earlier age. Fifty-three percent of annuity owners bought their first variable annuity before they were age 50. Buyers of equity indexed annuity contracts were also about 7 years younger than declared-rate annuity buyers.

Despite the obvious tax benefits that would appear attractive to wealthier investors, some advisers believe that the affluent generally avoid investing in annuities. That opinion isn’t supported by the demographic findings. Although slightly less than 6 percent of households overall own an annuity, about three times that percentage of individuals earning $200,000 or more own them. As might be expected, the percentage of annuity ownership and the median annuity value tend to increase as household income and net worth increase. The Federal Reserve Board’s Survey of Consumer Finances, published in January 2000, categorizes annuity ownership by income and asset levels as shown in the chart below.
### Household Income & Assets

<table>
<thead>
<tr>
<th>INCOME</th>
<th>Median Value Of Annuity Owned</th>
</tr>
</thead>
<tbody>
<tr>
<td>All families</td>
<td>$ 30,000</td>
</tr>
<tr>
<td>Under $75,000</td>
<td>26,000</td>
</tr>
<tr>
<td>$75,000 – 99,999</td>
<td>28,000</td>
</tr>
<tr>
<td>$100,000 – 199,999</td>
<td>60,000</td>
</tr>
<tr>
<td>$200,000 and over</td>
<td>70,000</td>
</tr>
</tbody>
</table>

### FINANCIAL ASSET LEVEL

<table>
<thead>
<tr>
<th>Financial Asset Level</th>
<th>Median Value Of Annuity Owned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $250,000</td>
<td>$ 18,000</td>
</tr>
<tr>
<td>$250,000 – 499,999</td>
<td>69,000</td>
</tr>
<tr>
<td>$500,000 – 999,999</td>
<td>95,000</td>
</tr>
<tr>
<td>$1 – 4.9 million</td>
<td>70,000</td>
</tr>
<tr>
<td>$5 million and over</td>
<td>131,000</td>
</tr>
</tbody>
</table>

It also appears that, irrespective of the income and asset category of the annuity purchaser, the funds invested in the annuity were the result of individual earnings rather than an inheritance.

### Annual Sales - Individual Annuities

When annuities first became popular in the late 1970s, fixed deferred annuities were marketed to older individuals who previously kept their money in 5¼ or 5½ percent savings accounts at their bank or savings and loan, the earnings on which were subject to income tax. Annuities offered a safe, tax-deferred alternative for their savings.

The most recent surge in the annuity market came in the mid-to-late 1990s with the growth of variable annuities in response to the unprecedented growth of the stock market. Variable annuities tend to be popular with both younger and older purchasers, capturing assets that would otherwise be invested in mutual funds.

In the mid-1990s equity indexed annuities were introduced with interest crediting linked to a stock index, such as the S&P 500 or the Dow-Jones Industrial Average. A type of fixed annuity with guaranteed principal, EIAs also offer the potential for higher rates of return tied to the stock market.
Because most annuities guarantee the return of the premiums paid into the contracts regardless of penalties, annuities also are marketed as alternatives to corporate and municipal bonds, whose values fluctuate with changing interest rates. When interest rates escalate in the open market, the value of any given bond fluctuates inversely. The higher the current interest rate, the less the old bond is worth. In contrast, a fixed annuity typically guarantees, at a minimum, to return the full premium or premiums deposited, and it protects its owner against loss of principal and market risk.

When annuities were first introduced, their underlying investment portfolio consisted of high-grade corporate bonds. Today's portfolios are much more diversified including various types of mortgages and asset-backed securities, as well as the traditional corporate bonds which still make-up most of the investment portfolio. Currently the annuity market has more than $1 trillion in assets under management.

According to VARDS, in 2000 Annuities were sold by the following:

- Career Life Agents 31%
- Stockbrokers 27%
- Independent Planners 24%
- Banks 15%
- Direct Response 3%

Along with the innovation of new designs for fixed, equity-indexed and variable annuities, carriers have also added features that can benefit policyholders and their families. Each of these features will be discussed in this course.

THE PURPOSE OF ANNUITIES

An annuity is defined as the liquidation of a principal sum to be distributed on a periodic payment basis to commence at a specific time and to continue throughout a specified period of time or for the duration of a designated life or lives.

According to the dictionary, the meaning of the word annuity is "annual payments." When an annuity is purchased, the insurance company agrees to systematically distribute the annuity's value as income over a specified period of time or for the duration of a designated life or lives.
TYPES OF ANNUITIES

Many types of annuities and numerous variations and options are available to consumers. The primary types of annuities can be classified as follows:

IMMEDIATE VS. DEFERRED ANNUITIES

Here the focus is on when payouts begin. With an immediate annuity, the insurer agrees to start making payments soon after the contract is signed. Immediate annuities are commonly used to convert a large amount, such as a lump-sum distribution from a qualified pension or profit-sharing plan, into an income stream. Payments from deferred annuities are delayed or deferred for a period of time after the premiums or contributions have been completed. Deferred annuities are frequently used when a person has cash to invest before retirement and wishes to postpone annuity payments until retirement or later.

IMMEDIATE ANNUITIES

An immediate annuity is designed to generate income payments almost immediately after it is purchased. Immediate annuity contracts can only be purchased with a single premium. Then, within a very short time, the contract "annuitizes" and begins to generate payments on a regular, structured basis. Each annuitized payment consists partly of principal and partly of interest earnings.

Most annuity payments are made monthly; however, many insurers allow the annuitant to elect a quarterly, a semiannual or an annual payment schedule.

How long an immediate annuity generates an income flow and the amount of each payment depends on a number of factors, such as the total amount of the annuity fund and the distribution or settlement option the contract owner selects. Payments can be made for a specified period of time, such as 5, 10 or 20 years (a term certain option); for the duration of the annuitant's life (a
life-income option); or for the duration of two lives (a joint and survivor option). Other payout options combine a term certain option with a life income option. Given a specified amount of annuity funds, the longer the period of income payments and the more guarantees the payout option provides, the smaller the amount of each payment.

The income flow from immediate annuities can be either fixed or variable. Under a fixed immediate annuity, the annuitant is guaranteed an income flow without risk that market fluctuations will affect the income amount; the insurance company absorbs the market risk associated with the investment of the annuity funds. A variable immediate annuity transfers the investment risk to the annuitant. This means that once an income stream is created, the payments can increase or decrease based on the performance of the underlying investments.

Immediate annuities solve the problem created by the uncertainty of whether a given sum of money will be sufficient to support someone for the remainder of his or her life. For example, a man, who is age 60, in good health, and recently retired has a lump sum of $100,000, but no other sources of income. He wants to enjoy the best lifestyle possible during his retirement. The problem is how long will the money have to last?

According to the 1980 Commissioners Standard Ordinary Mortality Table, the average life expectancy for a man age 60 is 17.5 years. He could plan his expenditures so that his money runs out when he turns age 77½. But 17.5 years is just an average-what if he lives past that age? There's also the possibility that he will die sooner than the average, in which case his money will not have been used to its fullest advantage during his retirement. The problem is how long will the money have to last?

If he spends too much now, sometime in the future he may find he has to reduce his spending on food or other necessities to make up for it. An immediate annuity solves the problem by guaranteeing an income for life.

According to one insurance company he can purchase a monthly income of $601 for life with his $100,000. Now he has a definite figure to budget with and can spend the money without having to worry about his financial future.

He doesn't need to buy an immediate annuity to liquidate his funds. He could keep the $100,000 in his own interest-bearing account and withdraw $601 at the end of every month and his funds would run out at about age 77½. But if he were still alive at that point, he'd have no money left, whereas with the annuity, the insurance company would continue to pay him $601 a month no matter how long he lived.

An individual cannot guarantee himself or herself a lifetime income except by purchasing an annuity. The guarantee of a lifetime income can only be accomplished through the pooling mechanism of insurance.

Immediate annuities provide many advantages to the buyer, such as:

- **Security** - the annuity provides stable lifetime income which can never be outlived or which may be guaranteed for a specified period;
- **Simplicity** - the annuitant does not have to manage his investments, watch markets, report interest or dividends;
- **Flexibility** - Payments can be received as frequently as needed to best meet the situation.
- **Stability** - Choosing a life option assures income that can't be outlived.
- **Choice** - Several different income payment options are available.
- **High Returns** - the interest rates used by insurance companies to calculate immediate annuity income are generally higher than CD or Treasury rates, and since part of the principal is returned with each payment, greater amounts are received than would be provided by interest alone;
- **Preferred Tax Treatment** - it lets them postpone paying taxes on some of the earnings accrued in a "tax-deferred" annuity when rolled into an immediate annuity (only the portion attributable to interest is taxable income, the bulk of the payments are nontaxable return of principal);

Since a Single Premium Immediate Annuity provides a guaranteed stream of payments to the annuity owner or annuitant, it is used in many instances where safety and timely income are the foremost concerns. Here are some examples where an income stream makes sense:

- **Retirement benefits** from employment with lump sum
• Terminal funding needs
• Pension terminations with lump sums
• Structured settlements on personal injury, estate or divorce cases
• Professional sports contracts
• Loan guarantee transactions

Unlike deferred annuities, immediate annuities cannot be surrendered or returned. The purchaser has relinquished control of their lump sum to the insurance company in exchange for the income stream.

The principal in an immediate annuity is not readily accessible. People who need more money than the income provided by the immediate annuity can minimize this drawback by keeping some of their retirement funds in a liquid account, such as a savings account or money market fund.

DEFERRED ANNUITIES

The primary purpose of a deferred annuity is to accumulate assets for the future over the long term.

"Deferred annuities" differ from immediate annuities in that the conversion of premiums into an income stream does not take place immediately, but is deferred for some period of time.

In contrast to the immediate annuity, which functions as a distribution vehicle, the deferred annuity is an accumulation vehicle. It is characterized by two distinct periods: the accumulation period and the payout (or distribution) period.

The accumulation period in a deferred annuity is the time during which funds, in the form of premium payments and interest earnings, are deposited into the contract and accumulate tax deferred.

During the accumulation phase, the money grows tax-deferred until it is withdrawn. The power of compounded tax-deferral delivers an advantage in achieving long-term retirement and financial goals. By deferring tax, consumers earn interest on principal, earnings and the savings in taxes that would normally be paid on taxable investments.

Suppose the client from our previous example decided to continue working until age 70. Since he has income from employment, he wants to delay the start of annuity payments for 10 years.

He can pay his $100,000 as a premium on a deferred annuity designed to begin annuity payments at age 70. Meanwhile, the annuity funds will accumulate earnings that will add to the amount available for conversion into an income stream.

For example, if the annuity pays 8% interest during the deferral period, the fund will grow to $215,892 over 10 years. At that point, because of the increased amount of money available for conversion and because of the reduced life expectancy at this older age, he could receive a guaranteed lifetime income of $1,831 a month.

Fixed Deferred Annuities

Money invested earns a specified rate of return on a tax-deferred basis. The insurance company usually sets the rate of return every year with a guaranteed minimum rate of generally 3 percent. The actual rate often exceeds the guaranteed minimum. When individuals decide to start receiving income, the insurance company will then pay a fixed amount every month. The pay-out amount will depend on the rate of interest that the premiums have earned.

Variable Deferred Annuities

Premium payments are used by the insurance company to purchase stocks, bonds or other types of securities per the contract owner’s choice. Any increase in the value of the securities is tax-deferred. The amount of pay-out depends on how well the securities perform.

Payout Period

The deferred annuity enters the payout phase at some point in the future when the owner decides to withdraw the annuity using a systematic formula for disbursing the values, called annuitization. Most deferred annuities specify a maturity date – the point at which the contracts are scheduled to annuitize and begin generating monthly income payments. Annuitization options include:

• Life
• Term Certain
• Joint-Life

Instead of, or prior to, annuitization, the owner could distribute the value of the annuity in one of the following ways:
Lump-sum distribution of the entire cash value
Systematic withdrawals

**Advantages of Deferred Annuities**

There are a number of good reasons to consider a deferred annuity as part of a financial retirement plan:

- Income taxes on any earnings is postponed until the money is withdrawn, typically during retirement, when clients may be in a lower tax bracket. All earnings grow tax-deferred.
- Clients can put in as much money as they want. Unlike Individual Retirement Accounts (IRAs), there is no IRS restriction on the amount that can be contributed annually to deferred annuities with your after-tax money.
- Death benefits can be provided to heirs. If clients die prematurely, their annuity can offer a death benefit to beneficiaries without the costs and delays of probate.

**DIFFERENCES BETWEEN DEFERRED AND IMMEDIATE ANNUITIES**

**Deferred Annuities**

- Includes both an accumulation and payout phase.
- Purchased to accumulate funds on a tax-deferred basis.
- Purchased with flexible premiums (allowing additional deposits) or with a single premium (one payment).
- Can be surrendered unless annuitization has already begun.

**Immediate Annuities**

- Includes only a payout phase.
- Purchased to convert a lump sum to an income stream.
- Must be purchased with a single premium payment.
- Cannot be surrendered, except during the free-look period.

**SINGLE vs. FLEXIBLE-PAYMENT ANNUITIES**

An annuity can be purchased in two ways:

- With one lump-sum payment (a single-premium annuity).
- With ongoing contributions (a flexible-payment annuity).

**SINGLE-PREMIUM ANNUITIES**

A single-premium annuity is purchased with a single lump sum premium payable at the inception of the contract. Generally the contract owner is not allowed to make additional deposits into the contract. Most of the sales volume in the annuity business today, as in the past, has been single premium. All immediate annuities must be funded by a single-premium, although not all single premium annuities are immediate. The contract holder can deposit the money into the annuity in one lump sum and let it remain there collecting interest until some time in the future when they decide to begin receiving annuity payments.

Single premium annuities are ideal for people who have come into large cash sums. A single premium annuity will convert such amounts, for example, from an inheritance, from the sale of a business or a large piece of real estate, or from a qualified pension or profit-sharing plan lump-sum distribution, into a lifetime or certain fixed period stream of payments.

**FLEXIBLE PREMIUM ANNUITIES**

A flexible-premium annuity is one purchased with periodic premiums payable on a flexible schedule. All flexible premium annuities are deferred annuities. Flexible premium annuities are used widely to fund individual retirement accounts (IRAs) and tax-sheltered annuities (TSAs).

Many companies have set up preauthorized contributions to their flexible premium annuity products by systematically transferring periodic sums from contract owners' checking or savings accounts into the annuities.

The duration of surrender charges tends to be somewhat longer and the charges somewhat higher. This is in part a result of additional administrative costs and the higher agent compensation typically found in flexible premium
contracts. Flexible premium annuities require the insurer to handle smaller amounts of money more frequently, resulting in higher administrative costs as well as the additional cost of data processing support.

Single Premium or Flexible Premium

Single Premium characteristics:

- Purchased with one lump sum
- Can have immediate or deferral annuities
- Lower administrative costs

Flexible Premium characteristics:

- Purchased with many periodic payments
- Can only fund deferral annuities
- Higher administrative costs
- Longer surrender charges

TYPES OF ANNUITIES ACCORDING TO INVESTMENT OPTIONS

There are three basic types of annuities: fixed, variable and indexed with the difference based on the underlying investments. Fixed annuities are invested primarily in bonds, bond funds or the insurer's general account. Variable annuities are invested primarily in stocks, stock funds or stock index funds. Equity indexed products are fixed annuities tied to the rise or fall of an investment index.

Fixed annuity owners appreciate stability. Fixed annuities offer assurances that cannot be found anywhere else. Variable annuities allow clients to enjoy the upside of the market but subject them to investment loss as well. Indexed annuities minimize downside risk by guaranteeing that the annuity value will earn a minimum rate of interest and that they not decrease below the initial premium.

FIXED ANNUITIES

Fixed Annuities are the least risky type of annuities. Interest rates are guaranteed by the insurer for a period of time by the carrier. While interest rates may fluctuate upward or downward over the term, fixed annuities are protected by a guaranteed minimum interest rate over the life of the policy. Fixed annuities may provide seniors with suitable alternatives to other conservative investments, such as certificates of deposit and municipal bonds.

A fixed annuity is designed to limit the contract owner's risk, including investment related risk, by providing a guaranteed return. This is accomplished when the insurer invests the annuity premiums in safe, secure investments, which provides a steady, although conservative, interest rate to the contract. This enables the insurer to guarantee the annuity benefit. With a fixed annuity, the values are guaranteed to the contract owner and the insurer assumes the investment risk. The insurer is required to provide the contractually promised values and benefits regardless of its rate of return.

Fixed annuities offer:

- **Guaranteed rate of interest.** For an initial period, the insurance company guarantees a fixed rate of interest.
- **Security.** Clients are guaranteed to receive back at least the principal paid into the annuity.
- **Flexible income options.** A client can choose a lump-sum payment, or equal payments over a specified period, including the rest of their life

Fixed annuities are invested primarily in government securities, and high-grade corporate bonds. They offer a guaranteed rate of return, typically over a period of one to ten years. The company pays for expenses (including commissions) and mortality costs out of the total return on the investments in the general account. They also leave a "spread" for profit.
VARIABLE ANNUITIES

In contrast to fixed annuities, “variable” annuities allow individuals to participate in the return of a separate investment account established to fund the annuity contract. There is no minimum guaranteed rate of return and individuals risk losing money, as they would with any investment. An individual’s return will reflect the investment experience of the separate account.

Variable annuities enable investment in a selection of funds, called sub-accounts. Available choices range from the most conservative, such as money market, guaranteed fixed accounts, and government bond funds, to more aggressive such as growth, small cap, mid cap, large cap, capital appreciation, aggressive growth, and emerging markets funds. Variable annuities also allow the transfer of money from one account to another without triggering a taxable event.

A variable annuity can be an important component of long-term retirement planning because it offers:

- Guaranteed future income that you cannot outlive
- No IRS imposed annual contribution limit on non-qualified money
- Opportunity for growth
- Tax deferral on any growth
- A broad range of investment choices
- Professional investment management
- Tax-free transfers between investment options
- Flexible retirement income options
- Retirement income protection
- Guaranteed death benefit for beneficiaries

The retirement income received from variable annuities depends on the performance of the investment options and the retirement income options selected. Because variable annuities invest in equity markets, they entail more risk than fixed annuities, but they also offer more growth potential. This opportunity for growth may help keep up with or even outpace inflation.

With Variable annuities there are typically two types of investment accounts: a general (guaranteed) account and a separate (variable) account. The variable or separate account offers a variety of subaccounts composed of stocks, bonds and money-market funds with the potential for higher returns but no guarantees. The contract owner determines how much premium is to be allocated to each account, based on his or her investment goals.

Because of the investment risk, variable annuities are legally considered to be securities and must be registered with the Securities and Exchange Commission (SEC) and agents must be both life licensed and registered with the National Association of Securities Dealers (NASD).

Variable annuities require an agent to have not only a life insurance license, but a variable license and a security license as well. The security license, either a series 6 or series 7, also allows an agent to sell mutual funds.

EQUITY INDEXED ANNUITIES

Equity Indexed annuities are a type of fixed deferred annuity that ties its interest crediting rates to a stock market index, such as, for example the S&P 500. They promise to pay some proportion of amount by which the underlying index has increased, if the index goes up, subject to annual caps.

Equity-Indexed Annuities combine the minimum interest rate guarantees offered by fixed annuities with the market-linked potential offered by variable annuities to create a product capable of generating market-linked returns without risk to principal. Equity-indexed annuities can be suitable investments for seniors who are willing to accept varying returns but cannot withstand the risk associated with investments like stocks, mutual funds or variable annuities.

If the market goes up, the investor is happy because the value of the annuity will increase. If the market goes down, the investor is still happy because the annuity has a guarantee. However, the gain on the index does not include dividends, if any, earned by the companies making up the index.

DIFFERENCES BETWEEN FIXED, VARIABLE & EQUITY INDEXED ANNUITIES

In all three types of annuities the earnings accumulate tax-deferred and can be used to
provide lifetime income. The basic difference between fixed and variable annuities is the way each credits earnings to the contract.

**Fixed Annuities**

- Interest rates are fixed for a stated period of time.
- Minimum interest rates are guaranteed for the policy duration.
- Once credited, gains are not susceptible to loss in the future.
- Principal is not subject to risk.

Amounts credited to cash values are based on the insurer’s current declared rate, subject to a minimum guarantee of about 4 percent to 4.5 percent. Rates may be guaranteed for one to five years. The currently declared rate depends on the performance of the insurer’s general investment portfolio or general account, which is largely invested in fixed income investments such as bonds and mortgages. Similar to a savings account, once interest is credited, the cash value will not decline if the market value of the underlying assets in the insurer’s general account declines. The insurer bears the market risk.

**Variable Annuities**

- Growth or loss based on performance of investment sub-accounts.
- Principal as well as previous earnings are subject to risk.

The annuity owner may choose to invest in a broad spectrum of separate accounts, which are similar to mutual funds. In contrast with fixed rate annuities, cash values depend on the market value of the underlying assets in the selected separate accounts. Variable annuity owners bear the market risk of investment without minimum interest rate guarantees. However, they have the flexibility to choose their investment portfolio and the potential to earn far greater total returns than on fixed rate annuities.

**Equity Index Annuities**

- Interest rates determined by changes in a major market index (i.e. S&P 500).
- Minimum interest rates are guaranteed for the policy duration.
- Principal is not subject to risk.

EIAs are a recently devised hybrid of fixed and variable annuities. The returns on EIAs are linked to an equity index, such as the S&P 500 index. However, the annuity is not actually invested in the stocks making up the index. Like fixed annuities, the returns to EIAs are paid from the insurance company’s general account. However, the amount allocated to the EIA is based on some percentage of the appreciation in the reference index, subject to annual caps. If the index declines in value, a minimum guaranteed amount is credited to the EIA. In this way, EIAs provide the upside potential of the equity markets with the downside protection of more conservative general account investments.

**PARTIES TO AN ANNUITY CONTRACT**

There are four parties to an annuity contract.

- **Insurer** - The insurance company who issues the contract and accepts the premium.
- **Owner** - The owner is the person or, in some cases, the entity that purchases the contract, designates the beneficiary, and holds most of the rights under the contract.
- **Annuittant** - The annuitant is a natural person on whose life income benefits will be based.
- **Beneficiary** - The beneficiary is the person or entity receiving the death benefit.

The annuity owner may choose to invest in a broad spectrum of separate accounts, which are similar to mutual funds. In contrast with fixed rate annuities, cash values depend on the market value of the underlying assets in the selected separate accounts. Variable annuity owners bear the market risk of investment without minimum interest rate guarantees. However, they have the flexibility to choose their investment portfolio and the potential to earn far greater total returns than on fixed rate annuities.

**Equity Index Annuities**

- Interest rates determined by changes in a major market index (i.e. S&P 500).
- Minimum interest rates are guaranteed for the policy duration.
- Principal is not subject to risk.

EIAs are a recently devised hybrid of fixed and variable annuities. The returns on EIAs are linked to an equity index, such as the S&P 500 index. However, the annuity is not actually invested in the stocks making up the index. Like fixed annuities, the returns to EIAs are paid from the insurance company's general account. However, the amount allocated to the EIA is based on some percentage of the appreciation in the reference index, subject to annual caps. If the index declines in value, a minimum guaranteed amount is credited to the EIA. In this way, EIAs provide the upside potential of the equity markets with the downside protection of more conservative general account investments.

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- **Beneficiary** - The beneficiary is the person or entity receiving the death benefit.
The contract owner can be any one of the following:

- Couple
- Trust
- Corporation
- Partnership

If the contract owner is an individual, he must be a legal adult. Minors may be contract owners only if the policy lists the minor's custodian. The contract owner controls the investment and can gift or will part or all of the contract to anyone or any entity.

**The Annuitant**

A *life insurance* policy names the insured party. The life policy continues in force until:

- The owner terminates the contract;
- The owner fails to make premium payments; or
- The insured dies.

With an annuity, the contract remains in force until:

- The contract owner makes a change; or
- The annuitant dies.

An annuitant is like an insured in a life policy. Although the annuitant must sign the annuity contract, the annuitant is subject to following restrictions:

- No control of the contract
- Cannot make withdrawals
- Cannot make deposits
- Cannot change the parties to the contract
- Cannot terminate the contract

The contract owner may name anyone as the annuitant—the contract owner, spouse, parent, child, relative, friend or neighbor. The annuitant must be a *person* (not living trust, corporation, partnership etc.) currently living. This is the only qualification in naming an annuitant.

The maximum age allowed for the annuitant depends on the insurance company issuing the annuity contract. As a rule, the annuitant must be under age 75 at date of signing. Some companies set a maximum age of 70 or 80. The contract may still be in force even though the annuitant has reached the maximum age limit.

Most annuities provide that the contract owner may change the annuitant at any time, with the stipulation that the new annuitant was alive when the original contract was executed.

**Beneficiary**

The beneficiary of an annuity will only benefit or prosper from that annuity upon the death of the annuitant. The named beneficiary(s) can be children of the annuitant, friends, relatives, spouse, neighbors, trusts, a corporation or a partnership. The annuity application will allow multiple beneficiary designations of varying or similar proportions.

An annuity is a contract between an annuity owner and an insurance company. However, the contract's rights and benefits are measured by the life of a third party, the annuitant. In addition, disbursement of annuity values which occurs after the death of the contract owner or annuitant goes to the beneficiary.

Deciding who to name as the owner, annuitant, and beneficiary of an annuity is commonly referred to as "structuring the contract." Usually, the structure of an annuity contract is kept fairly simple by naming the same individual as both owner and annuitant. If that individual dies, any remaining annuity value is paid to the beneficiary.

However, there are situations that call for the annuitant to be someone other than the owner of the annuity. In such cases, agents must take care to ensure that this does not result in unintended consequences.

What can complicate the matter is that owner, annuitant, and beneficiary provisions vary somewhat from contract to contract. For example, under some contracts, the owner would automatically become the annuitant and the annuity would simply continue if the annuitant died while he was still alive. Under other contracts, the value of the annuity would immediately be paid to the beneficiary and the contract would cease upon the annuitant's death regardless of whether the owner was still living. There are other possibilities. Only by reading the contract in question can you determine what rights and benefits pertain to the various parties under a particular annuity.

A complex structure may be appropriate in certain cases, but in most situations, the simple contract structure, with its more straightforward control and...
benefit flow, is the most desirable way to structure the contract.

**RIGHTS AND OBLIGATIONS OF THE OWNER**

The owner of an annuity enters into the contract with the insurer. It is the owner who makes the premium deposits to buy the contract, and it is the owner who enjoys the tax deferral. As long as the owner is alive, only he or she can control decisions relating to the annuity. These decisions include annuitization, withdrawals, surrenders or changes in designating the annuitant or beneficiary. The owner's death typically triggers a payment of all annuity accumulation value to the beneficiary.

The contract owner holds key rights under an annuity contract. While the annuitant is living, the contract owner generally has the power to do the following:

- Name the annuitant
- Select and change the annuity starting date
- Select and change (prior to the annuity starting date) the payout options
- Name and change the beneficiary
- Request and receive the proceeds of a partial or full surrender
- Initiate and change systematic withdrawals
- Assign or otherwise transfer ownership of the contract to other parties
- Amend the contract with the issuing company's consent
- Re-allocate proceeds (i.e. variable annuity and equity-indexed annuity)

Some annuity contracts allow the owner to change the annuitant and others do not. If the owner of the contract is not a natural person, a change of annuitant is treated the same as the death of an owner for income tax purposes, which means that certain distributions are required to be made from the contract. Therefore, care should be taken in naming the annuitant when the owner is a nonnatural person in order to avoid unfavorable tax consequences if a change of annuitant is later desired.

Under many (but not all) annuities, the owner's rights in the contract cease when the annuitant dies, and one of two things happens: either the value of the annuity is paid to the beneficiary or the beneficiary becomes the new owner. Usually, but not always, the owner and annuitant are the same person. This doesn't present a problem where the owner and the annuitant are the same person. But care must be taken in those situations where the owner and the annuitant are different parties.

Under other contracts, the owner's rights do not automatically cease when the annuitant dies. If the owner is not the annuitant and the annuitant dies first, some contracts provide that the owner automatically becomes the annuitant. Other contracts provide for a period of time in which the owner can name a new annuitant, after which, if a new annuitant is not named, the owner becomes the new annuitant. Still other contracts provide for a contingent owner to assume ownership of the contract in the event the original owner dies before the annuitant.

In general, it is the owner of the annuity who is taxed on any amounts disbursed from the annuity during the annuitant's lifetime, even if someone else is receiving annuity benefit payments. Naming another person as annuitant does not shift tax liability away from the owner. Only a gift or other transfer of ownership can do that.

**JOINT OWNERSHIP**

There are rules designed to prevent the use of joint ownership to obtain tax deferral on annuity earnings over more than one lifetime, except in the case of married couples.

For contracts issued today, there are only a few situations that might call for joint ownership of an annuity. In the case of married couples, the effect of joint ownership for purposes of successor ownership is best obtained by having one spouse be the owner and the other spouse be the beneficiary. In the event of the owner's death, the spouse can succeed to ownership by application of the spousal exception to the required distribution rule.

If joint ownership by a married couple is desirable for other reasons, be sure that each spouse names the other as primary beneficiary for the spousal exception to the required distribution rules to apply, the surviving spouse must be the designated beneficiary of the contract. If someone other than the surviving spouse is the designated beneficiary, then even if the surviving spouse is a joint owner, the spousal exception is lost.

With joint ownership of an annuity, the signatures of both owners are required to exercise the rights of
ownership. Also, each joint owner assumes the tax liability for one-half of every withdrawal, even if the entire withdrawal was spent by only one of the owners. Any joint owner under age 59½ would also be liable for the 10% penalty tax on any taxable amount of his or her portion of the withdrawal, unless an exception applied. Also joint ownership of IRAs is prohibited by the law governing IRAs.

Owners in an annuity contract may be a natural person or an entity, such as a corporation or a trust.

The "Non-natural Person" Rule

Another special income tax rule that prospective purchasers of annuity contracts should be aware of is the "non-natural person" rule. This provides that a deferred annuity contract held by an owner other than a human being (such as a trust or business entity) will generally not be treated as an annuity for income tax purposes. If the rule applies, the tax deferral feature of the annuity will be lost, and the income earned on the contract will be taxed each year to the contract owner, regardless of whether any distributions from the contract are made.

The rule does not apply where the:

- contract is owned by the estate of a deceased annuity owner
- annuity contract is an immediate annuity
- annuity contract is owned by an IRA or a qualified plan of deferred compensation
- entity owns the annuity as an "agent for a natural person" i.e. certain types of trusts.

Any situation in which trust ownership is proposed for an annuity should be reviewed by a competent tax professional.

OWNER-DRIVEN OR ANNUITANT-DRIVEN CONTRACTS

Annuity carriers may structure an annuity contract as owner-driven or annuitant-driven.

In owner-driven contracts where the owner is a natural person, the owner's right in the contract dissolves upon the owner's death. In an owner-driven contract, the owner has the right to name a new annuitant.

In owner-driven contracts where the owner is a corporation or nonnatural person, the primary annuitant is treated as the owner. Under these circumstances, death of the annuitant would trigger a distribution from the contract.

In annuitant-driven contracts, the owner's rights dissolve upon the death of the annuitant.

RIGHTS AND OBLIGATIONS OF THE ANNUITANT

The annuitant's obligations within an annuity contract are very limited. In most annuity contracts the annuitant is the individual who will receive the income benefits under the contract.

It is the annuitant's life expectancy which determines the benefits payable under an annuity. And it is the attainment of a given age on the part of the annuitant that triggers the annuity starting date under an annuity. The benefits themselves may actually be paid to a different party.

Some contracts allow joint annuitants, however, this may unnecessarily increase the risk that unwanted changes will be made to the contract prior to the annuity starting date. The increased risk of naming joint annuitants may be unnecessary because a joint-and-survivor income option can be chosen if a guaranteed lifetime income stream over the lives of two individuals is desired.

It is generally the owner rather than the annuitant who is taxed on annuity payments. If the owner and the annuitant are the same person, of course, it is the owner/annuitant who is taxed. However it is with reference to the annuitant's life that the exclusion ratio for the payment is calculated.

Also, some contracts provide that the annuitant will become the owner of the contract after annuitization. In that case, the annuitant, as owner, would become liable for the tax on the income-taxable portion of those payments.

The Entities Eligible for the Role of Annuitant

The annuitant must be an individual (or in the case of joint annuitants, two individuals). If a trust, corporation, or other nonnatural person were the annuitant, there would be no natural life by which to measure the benefits of the contract. The annuitant and the owner do not have to be the same.
The Role of Annuitant in Owner-Driven Contracts

In owner-driven contracts, the role of the annuitant is to establish the income benefits at the time of annuitization.

The Role of Annuitant in Annuitant-Driven Contracts

While the same is true of an annuitant-driven contract, the annuitant's death also triggers a distribution from the contract, payable to the designated beneficiary, and all of the owner's rights dissolve.

Rights and Obligations of the Insurer

Insurance companies have responsibilities to policyholders, agents, investors, and insurance regulators including:

To Manage Investments

For the benefit of its policyholders, agents, and investors, an insurance company must manage its investment portfolio wisely.

To Administer Contract Provisions and Benefits

When a consumer purchases an annuity, the insurer assumes a duty to administer the benefits and provisions of the contract indefinitely.

Insurer Responsibilities to All Consumers

- Notify existing insurer of proposed replacement
- Maintain replacement records for three years
- Include with the policy a notice informing the policy owner of the free-look provision.

Non-qualified Annuity Contracts May Require The Insurer To Administer The Following:

- Flexible deposits
- Systematic withdrawals
- Policy owner changes
- Partial and full surrenders
- Annual statements
- Re-allocaing interest strategies
- Annuitization benefits
- Distributions upon death
- Tax reporting of non-death distributions
- Tax reporting of death benefit distributions
- Income tax withholding for Non-qualified stretch benefits withdrawals, death benefits, and annuitization options
- Policy cancellations and refunds

Qualified Annuity Contracts May Require The Insurer To Administer The Following:

- Minimum Required Distributions
- IRS reporting requirements of qualified contributions
- IRS reporting requirements of qualified rollovers
- IRS reporting requirements for 10% excise tax on early distributions
- Stretch IRA benefits
COMPANY FINANCIAL STABILITY & RATING SERVICES

Another concern in recommending the right product is the financial stability of the company issuing the annuity.

When it comes to annuities, many agents put too much weight on product features and not enough on the insurer's financial strength and stability. An annuity policy is only as secure as the company issuing it. There are a number of independent rating services to help you and your clients evaluate an insurance company's financial strength and stability.

No rating provides an absolute guarantee of continued solvency, but the ratings do offer an expert, informed opinion about a company's financial condition based on a thorough analysis of the company's circumstances. The major rating services for insurance companies are:

- A. M. Best Company
- Standard & Poor's
- Duff & Phelps
- Weiss Research
- Moody's Investors Service

Unauthorized Entities

There is a substantial problem with licensed agents selling unapproved insurance and other services through unauthorized entities. In many of these cases, the agents failed to recognize that the entities were not licensed insurance companies with the state's Department of Insurance. The problem has resulted in the loss of hundreds of millions of dollars to policyholders, due to unpaid claims and theft of premiums.

It is incumbent upon insurance agents to do complete due diligence on any product or service to be provided, and to educate themselves on the laws and issues relating to this problem. Failure to do so can result in significant embarrassment with a client, and could perhaps lead to fines, censures, and/or loss of one’s license. Agents would do well to make sure that all vendors with whom they work are fully licensed to do business with the state's Department of Insurance and that the products are approved for sale in said state.

If you follow the ethics standards required by the CFP Board of Standards or the Financial Planning Association, you will keep yourself on the right track.

Agent's Responsibility Presenting Illustrations

Because the annuity is an investment product, it lends itself to being sold by illustration and projections. And because of market conduct issues and the potential for misuse of product illustrations, intentional or not, extreme care must be taken with respect to what can and should be illustrated and projected. Illustrations are also regulated by law.

VARIABLE ANNUITY ILLUSTRATIONS

For variable annuities, the NASD has addressed this issue and responded with established standards that agents must adhere to when creating illustrations and proposals. Because these illustrations and proposals (or more likely, the software programs that generate them) are provided by insurers, the agent need not be overly concerned with them in practice. As background, though, some information is useful.

A proposal or an illustration cannot show growth in a variable annuity and compare it to a non-tax-deferred investment unless the annuity also is shown on an after-tax basis in the same illustration. Hypothetical performance cannot be used to illustrate future values; however, an assumed interest rate can be used to project values into the future. A subaccount's past performance can be used to paint a retrospective picture.

FIXED ANNUITY ILLUSTRATIONS

For fixed annuities, states as well as the NAIC have developed guidelines for illustrations. Agents are accustomed to using illustrations when presenting annuity concepts, often using software to generate illustrations. Agents’ duties under California's Insurance Code when presenting illustrations are:

Agent's Responsibility to Comply With Replacement Guidelines

The exchange of one annuity for another has come under considerable scrutiny and criticism in recent years based on questionable suitability of some of the exchanges.
Studies show that a large percentage of the annuities sold replaced previous annuities. Regulators are concerned with inappropriate “churning” of annuities which are designed to be held long-term.

According to statistics compiled by the National Association of Variable Annuities during the calendar year 2002, approximately $113.7 billion in variable annuity (VA) sales was recorded by the 25 largest annuity writers in the United States (source: NAVA Outlook, March/April 2003). Of this sum, NAVA estimated that close to 73 percent of sales during 2002 were exchanges from one product to another.

The trend to exchange has been noticeable for years and the National Association of Securities Dealers (NASD) issued an investor alert in early 2001 regarding the wisdom behind exchanging one variable annuity policy for another. In January 2004, the NASD charged a large broker/dealer with allegedly switching 6,700 variable annuity policies, of which 1,400 were likely to lose money. Source: NASD website, 2004.

Agents who replace annuities or life insurance with new annuities have certain basic responsibilities that apply to consumers.

When an agent takes an application for an annuity, a statement must be provided to the insurer signed by both the agent and the applicant indicating whether replacement of an existing annuity or life insurance contract is involved. In the event replacement is involved, the agent has additional requirements to present the applicant with the Notice Regarding Replacement at the time the application is taken.

- The Notice Regarding Replacement must:
  - List all existing life insurance and annuity contracts to be replaced
  - Properly identify the insurer, contract number(s), and insured/owner
  - Be signed by both agent and applicant
- Leave the Notice Regarding Replacement with the applicant;
- Leave the applicant with a copy of all printed communications used during the presentation;
- Provide the replacing insurer with a copy of the completed Notice Regarding Replacement with the application.

Agents, who are attempting to conserve a replacement, must leave any written or printed communications used to conserve the business with the applicant.

A violation occurs if an agent recommends the replacement of an existing annuity when an inaccurate presentation or comparison of premiums, benefits, dividends and values are made. Agents must evaluate the replacement on the basis of whether all of these aspects are equal to or better than the existing annuity.

Agents must be much more careful when working with replacements. Since stiffer fines for violations also went into affect agents are advised to keep good records to support recommendations involving replacements.

**Agent’s Responsibility Regarding the Free-look Period**

With a fixed annuity, the "free look" provision, also called the right-to-examine or right-to-cancel provision is fairly straightforward. The owner is given a period of time beginning with the date on which the contract is delivered to change his or her mind. If the owner returns the contract, he or she is given a full refund of any premium paid. No surrender charges or other fees are deducted from the amount refunded.

The situation is not as simple with a variable annuity. Most variable annuities provide for immediate allocation of the premium according to the owner's instructions. In such cases, the contract generally provides that the amount subject to refund during the free look period will be based on the value of the investment options in the separate account (plus any charges deducted before the premium was credited to the separate account) rather than the premium paid. Otherwise, if investment experience were poor during the free look period, annuity owners could recoup their losses simply by returning the contract.

**IMPORTANCE OF READING THE CONTRACT**

Understanding the provisions of the contracts you sell can only be done by reading the contracts themselves. Agents should not be satisfied with a summary of the features since the wording of similar provisions can vary from one contract to
another. This difference in wording can lead to substantially different outcomes for your clients.

**RIGHTS OF THE BENEFICIARY**

The benefits of an annuity are designed to flow primarily to the owner and annuitant. Rights of the beneficiary begin only after the death of either the owner or the annuitant, depending on whether the contract is owner-driven or annuitant-driven.

While it is the owner who is taxed on an annuity during the annuitant's life, upon the annuitant's death it is the beneficiary who becomes liable for income tax on any gain paid out of the contract.

Also, in some cases, the beneficiary may become liable for the 10% penalty tax on premature distributions because of the way the definition of "premature distribution" is written in the tax law for annuities purchased on a nonqualified basis. The 10% premature distribution penalty tax rule for qualified plans, would allow any beneficiary to avoid the penalty tax in the event of the annuitant's death.

Therefore, if an annuity is purchased on a nonqualified basis and the owner of the annuity is a natural person and is not the annuitant; the annuitant's beneficiary will be liable for the 10% penalty tax if he or she receives taxable death proceeds from the annuity when he or she is under age 59½.

**The Entities Eligible for the Role of Beneficiary**

The beneficiary in an annuity may be a natural person or an entity, such as a trust. More than one beneficiary can be named under an annuity. Most annuities provide that if more than one beneficiary is named, equal shares will be paid to each beneficiary unless the owner has specified otherwise.

In most cases, the beneficiary is the owner's spouse so that the spousal exception to the required distribution rules can be used to continue the contract in the event of the owner's death. Sometimes it is appropriate for the owner to name his or her child or children as beneficiaries. If a beneficiary is a minor child, the owner should have a will and name a guardian to receive the benefits on the child's behalf. Otherwise, the child's lack of legal competence will likely cause the insurer to delay paying the benefits until a guardian is appointed by a court.

In a few cases, it may be appropriate to name a trust or estate beneficiary under an annuity. If the proceeds are paid to a nonnatural person as a required distribution upon the owner's death prior to the annuity starting date, proceeds must be distributed within five years. The annuitization option will not be available, since the beneficiary is not a natural person.

Most annuities reserve the contract owner's right to change the beneficiary at any time during the annuitant's life. However, some contracts give the owner the option of naming a permanent, or irrevocable, beneficiary. If an irrevocable beneficiary is named, the beneficiary designation can later be changed only with the beneficiary's consent.

**SETTLEMENT OPTIONS AVAILABLE TO THE BENEFICIARY**

Settlement options for the beneficiary after the death of either the owner or the annuitant, depends on whether the contract is owner-driven or annuitant-driven. Agents should carefully structure the contract so the contract owner's expectations will be met.

The options to beneficiaries are addressed in Section 72 of the Internal Revenue Code (IRC) and are generally based on one of three beneficiary types:

- Primary beneficiary is a surviving spouse; or
- Primary beneficiary is an individual other than a surviving spouse; or
- Primary beneficiary is an entity.

**Primary Beneficiary Is Surviving Spouse**

If the beneficiary is designated as the surviving spouse, the beneficiary has the following settlement options:

- Assume ownership and continue the contract; or
- Take the proceeds as a lump sum distribution no later than the end of the calendar year following the year which death occurs; or
- Take the proceeds by the end of the calendar year containing the fifth anniversary of death; or
• Take the proceeds over the beneficiary’s life expectancy with payments beginning no later than the end of the calendar year following the year which death occurs

Primary Beneficiary Is an Individual Other Than a Surviving Spouse

If the beneficiary is designated as an individual other than a surviving spouse, the beneficiary has the following settlement options:

• Take the proceeds as a lump sum distribution no later than the end of the calendar year following the year which death occurs; or
• Take the proceeds by the end of the calendar year containing the fifth anniversary of death; or
• Take the proceeds over the beneficiary's life expectancy with payments beginning no later than the end of the calendar year following the year which death occurs

Primary Beneficiary Is Entity

If the beneficiary is designated as an entity (such as a corporation or trust), the beneficiary has the following settlement options:

• Take the proceeds as a lump sum distribution no later than the end of the calendar year following the year which death occurs; or
• Take the proceeds by the end of the calendar year containing the fifth anniversary of death

Most insurance companies allow death benefits to be paid as a lump sum, however. Some annuities require a five-year distribution with these contracts, carriers will assess surrender charges if the beneficiary takes a lump sum distribution.
ANNUITY CONTRACT PROVISIONS

PROVISIONS COMMON TO MOST ANNUITIES

While each annuity described has its own unique characteristics, certain provisions are common to all contracts. This section covers the provisions commonly found among all annuities, after which we will look at those specific to fixed, equity-indexed and variable annuity contracts.

Interest rates and compensation

Insurers have several ways of crediting (paying) interest on the funds in an annuity. All insurance companies provide their contract owners with annual statements that contain basic information relative to account values and transactions. Some insurers prepare this accounting at the end of each contract year, and some do so at the end of each calendar year. Regardless of when a statement is prepared, it provides information on all activity within that account during the year.

BONUS PROVISIONS

Some companies offer a "bonus" rate of interest that will be paid on top of the current, or "base" rate offered on the contract. Interest rate bonuses are generally guaranteed for one interest-crediting period, which is usually one year.

The bonus may be in the form of an additional interest rate credited in the first year, or it may be a percent of premium which is credited to the contract immediately, which simply adds an amount to the contract owner's premium deposit at contract issue. Bonuses are popular with variable annuities.

Not all annuity contracts contain bonuses, but those that do are in one of two forms - interest rate bonuses or premium bonuses. Interest rate bonuses vest over the course of a contract year, while premium bonuses vest immediately.

If explained and deployed suitably, bonus annuities can be a valuable tool, provided consumers understand that bonuses eventually come to an end. There have been instances where agents misrepresented bonus annuities in presentations and advertisements. The "teaser rates" attached to the first year rate were never explained properly by the agent or in the advertisements. Upon renewal, interest rates were far lower than the first year rate but surrender charges associated with such contracts which made liquidation too costly.

Agents should be careful when working with clients who already own an annuity and are thinking of exchanging it for a different annuity with a bonus feature should be careful. Even if the surrender period on the current annuity contract has expired, a new surrender period generally will begin when it is exchanged for a new one. This means that, by exchanging the contract, they will forfeit the ability to withdraw money from their account without incurring substantial surrender charges. And the surrender charges and other fees may be higher on the variable annuity with the bonus credit than they were on the annuity that was exchanged.

Agents have often used bonus annuities to offset surrender charges from replaced annuity contracts.

Some annuity companies offer "bonus" interest to induce an annuitant to initiate a contract or to take a lump sum from an existing annuity and transfer it to them. Using bonus annuities to offset surrender charges with seniors, is risky since the bonus alone may not create a substantial financial benefit over the life of the policy required by law, especially if other provisions are not at least equivalent to the annuity being replaced.

Example: an insurer offers a base rate of 5.50% but with a 4.00% first year bonus. Looks great with an advertisement of 9.50% the first year. Another insurer only has a 6.25% overall rate and NO bonus. In seven years with the bonus, would be $150,983. But the 6.25% rate would be $152,863. While not a huge difference, the difference gets larger and larger as time goes on.

Annuities that offer a bonus credit often have higher charges than annuities with no bonus credit. Assuming that both annuities have the same annual rate of return, prior to expenses, the annuity that will grow the most over the long-haul may well be the one that deducts lower annual charges, even though it does not offer a bonus. Frequently, insurers will offset bonus credits in one or more of the following ways:

- Higher surrender charges – Surrender charges may be higher for a variable annuity that pays a bonus credit than for a similar contract with no bonus credit.
Longer surrender periods – Surrender charges may apply for a longer period than they would be under a similar contract with no bonus credit.

Higher mortality and expense risk charges and other charges – Higher annual mortality and expense risk charges may be deducted for a variable annuity that pays a bonus credit. Although the difference may seem small, over time it can add up.

Before recommending a variable annuity with a bonus credit, agents should determine whether the bonus is worth more than any increased charges for the bonus. This may depend on a variety of factors, including the amount of the bonus credit and the increased charges, how long annuity contract the annuity is held, and the return on the underlying investments. Agents also need to consider the other features of the annuity to determine whether it is a good investment for their clients.

Under some annuity contracts, the insurer will revoke all bonus payments made within a specified period if clients make a withdrawal, if a death benefit is paid to beneficiaries upon death, or under certain other circumstances.

TWO-TIERED ANNUITIES

Two-tiered annuities offer relatively high rates, but only if the owner holds the contract for a certain number of years and then annuitizes it. If the annuity is surrendered at any point, interest credited to the contract is recalculated from the contract's inception using a lower tier of rates. The contract owner gets one tier of interest rates by staying with the contract through annuitization and another, lower tier of rates if he or she does not.

These products are used most often in the tax-sheltered annuity market with teachers. Agents who sell two-tiered annuities must make sure that clients know how the product works and are prepared to commit themselves and their beneficiaries to the annuity for a long term.

MATURE DATE - MAXIMUM AGES FOR BENEFITS TO BEGIN

Every deferred annuity contract specifies a maturity date or annuity date, which is the date on which annuitized payments are scheduled to begin. A contract's maturity date usually is the later of 10 contract years or the contract anniversary that falls in the year the annuitant reaches age 85. (In some contracts, the maturity age is 100.) Most insurers allow a contract owner/annuitant to continue the deferral period for some time past the maturity date or annuitize the contract before the maturity date.

Typically, an annuity contract provides the insurer has a right to require proof that the annuitant is living on the date of any annuity payment.

CRISIS WAIVER PROVISIONS

Crisis waivers allow policyholders to liquidate some or all of the annuity's value due to catastrophic events free of surrender charges.

The Variable Annuity Research and Data Service (VARDS) reports that 161 variable annuity contracts offer some type of waiver. Similarly, Beacon Research, an annuity-tracking service based in Illinois, surveyed 282 fixed annuities and found that 35 percent have a death waiver; 18.5 percent contain nursing home waivers; 7.4 percent have hospital waivers; and a mere 2.3 percent carry disability waivers.

While a death waiver is most common in the fixed annuities survey, VARDS shows the most popular waiver found in variable annuities is the nursing home waiver, with 103 variable annuity contracts containing that provision; 83 provide death waivers; 69 have terminal illness waivers; and 42 carry disability waivers.

Situations that trigger the waiver and allow early annuity withdrawals vary from company to company. The agent should review such provisions carefully to determine whether any definitional restrictions exist and to understand how broadly or narrowly these provisions apply. It's important to read the policy to find out if it contains any provision under which the surrender or withdrawal would be waived.

Annuity contracts may contain some or all of the following crisis waivers.

Nursing Home Waiver

The nursing home waiver eliminates surrender charges upon withdrawal in the event of a nursing home admission.

- May be annuitant or owner triggered
• May take effect immediately or beginning on the first anniversary
• Usually requires confinement of 30, 60, or 90 consecutive days
• Benefit may be reduced for older purchasers
• Attending physician’s statement may be required along with a completed claim form.

While a 90-day confinement period before benefits kick in may be typical, some insurers impose a 180-day confinement period to a “licensed nursing facility.”

**Hospital Waiver**

A hospital waiver which eliminates surrender charges upon withdrawal in the event of an extended hospital confinement after the annuity was purchased.

• May be annuitant or owner triggered
• May take effect immediately or beginning on the first anniversary
• Usually requires confinement of 30, 60, or 90 consecutive days
• Benefit may be reduced for older purchasers

**Terminal Illness Waiver**

The terminal illness waiver eliminates surrender charges upon withdrawal if diagnosed with terminal illness.

• Terminal illness may be diagnosed differently (i.e. less than 6 months to live, less than 12 months to live)
• May be annuitant or owner triggered
• May take effect immediately or beginning on the first anniversary
• Will require certification from a doctor that life expectancy is only a matter of months.
• Benefit may be reduced for older purchasers (e.g. for purchaser older than aged 75, only 50% of account value may be surrendered)

**Unemployment Waiver**

The unemployment waiver eliminates surrender charges upon withdrawal if unemployment occurs, provided the annuity was purchased prior.

• Unemployment must be involuntary
• May require proof of gainful employment
• May be annuitant or owner triggered

**Disability Waiver**

The disability waiver eliminates surrender charges upon withdrawal if physical disability develops.

• May require Social Security Disability benefits as a prerequisite
• May be annuitant or owner triggered
• May take effect immediately or beginning on the first anniversary
• May not be available if over the age of 65 at the time of purchase

**Crisis Waiver Charges and Fees**

In most cases, there’s no extra charge for waivers because they’re built into the contract when purchased. Variable annuity contracts may offer crisis waivers for an additional expense. Certain tax consequences could apply to such withdrawals. Check with a tax adviser.

**PREMIUM PAYMENT PROVISIONS**

All companies have provisions regarding payment of premiums. Annuity contracts accept flexible premiums or a single premium. Since flexible premium contracts are designed to encourage systematic saving, insurers typically set relatively low requirements for additional deposits.

**MINIMUM & MAXIMUM PREMIUM PAYMENTS**

Companies generally set minimum and maximum limits on the premium amounts they will accept. Minimum limits are set in order to control the administrative costs the company incurs to credit each premium to the contract. Maximum limits are set in order to manage the company’s liability for benefit payments under the contract. Minimum and maximum limits vary among companies and types of contracts. Most insurers set maximum allowable deposits based on the insurer’s ability to assume the liability of the contract.

Tax-qualified plans, like IRAs and 403bs, have maximum allowable contributions that prevail when used with annuities.
Minimum premiums are much lower on flexible premium annuities compared to single premium annuities, since the flexible premium product is designed specifically to accommodate the payment of a number of relatively small premiums over a period of time. However, typical minimums vary widely depending on the market in which the company expects to sell the product and the amount of administrative cost the company expects to incur.

Sometimes the company will also limit the frequency with which premium payments may be made. A separate set of minimums may apply if premiums are being paid via an automatic payment plan (such as automatic monthly transfers from the owner's checking account) or if the annuity is purchased under a qualified plan.

For single premium products, minimum premiums are typically $5,000 or $10,000. Many single premium contracts do not allow any premium payments other than the initial premium. However, some are designed to accept a certain number of additional premium payments within a limited period of time.

**MISSTATEMENT OF AGE OR SEX**

An annuity contract includes a clause that provides for a benefit adjustment if the annuitant's age or sex is misstated in the application. This provision adjusts benefits to those that the premium would have purchased at the correct age or sex.

Generally, the payment amount is adjusted and any amounts overpaid are charged against the next payments made to the payee. Any amounts underpaid are added to the next payment. The company sometimes reserves the right to collect from the payee any amounts overpaid.

**Settlement options upon death of owner or annuitant**

The owner has the right to name and change the beneficiary of the contract, unless the owner decides to make the beneficiary irrevocable, in which case the owner's rights for withdrawals, annuitization and changing the beneficiary would require the beneficiary's consent.

**Beneficiary’s Rights To Death Benefits Prior To Annuitization**

When a contract owner dies before annuitization the beneficiary has rights to the entire interest.

**Beneficiary’s Rights To Death Benefits After Annuitization**

When a contract owner dies after receiving benefits the beneficiary is entitled to the remaining years of benefits.

**STRETCH PROVISIONS FOR QUALIFIED ANNUITIES**

In January, 2001 the IRS issued new rules governing the distribution phase of IRAs. One of the features of the new 2001 rules is that IRA owners are now permitted to take smaller Minimum Required Distributions (MRD).

Under the old rules, Individual Retirement Accounts (IRAs) were created to let individuals use the advantage of tax deferral to accumulate funds for retirement until they reached the age of 70½. At that point, individuals were required by law to begin withdrawing funds annually because the IRS wanted them to withdraw all of their money and pay all of the taxes before they died. And if a person did not take distributions or if the amount distributed was not large enough, he or she faced a severe tax penalty equal to 50% of the amount by which the required minimum distribution amount exceeded the actual amount distributed.

And to make matters worse, the amount of the required minimum distributions increased annually. So not only must they pay taxes on increasing distributions they do not need, but the benefits of future tax deferral and compounding on the amount distributed was also lost.

Under the old rules the distribution from an inherited IRA had to be withdrawn by the beneficiary over a period no greater than five years. New tables allow individuals to take smaller distributions each year, thereby maintaining tax-deferred compounding of the balance. Beneficiaries may continue distributions based on their own individual life expectancies.

Under the new rules, each beneficiary of an inherited IRA is entitled to "stretch" out the inherited IRA distribution over their individual life expectancy. By stretching the death benefits over the course of the beneficiary's life expectancy, the amount remaining in the IRA can continue to benefit from
tax-deferred growth. Also the beneficiary can lower the tax by lengthening the distribution period. The new rules also apply to annuities used in qualified plans.

Under the new rules, the age of a spouse beneficiary determines which IRS table is used to determine the owner’s required minimum distribution amounts. If the spouse is less than 10 years younger (as with most beneficiaries), the owner uses the Uniform Lifetime Table, and his or her payment amounts are based on his or her sole life expectancy. If the spouse beneficiary is more than 10 years younger, however, the owner uses the Joint Life Expectancy Table to determine the applicable life expectancy factor which results in smaller annual distributions.

If the annuity owner dies before his or her spouse beneficiary, the spouse can assume ownership of the annuity and begin new minimum distributions based on his or her own age. This Spousal Rollover option stretches the income over a longer distribution period, and provides an income stream, increased independence and security for the spouse.

Taking advantage of the new rules to stretch annuity distributions over time is not for everyone, but if clients already have all the income they need to maintain their lifestyle and they want to take advantage of tax-deferred growth and compounding to pass greater wealth on to his or her loved ones, they may want to learn more about how the new rules can work for them.

**STRETCH PROVISIONS FOR NON-QUALIFIED ANNUITIES**

With some exceptions, Internal Revenue Code allows the death benefit from a nonqualified annuity to be extended over the beneficiary’s life expectancy as calculated by the “uniform table” used for determining MRD regulations. By electing a “non-qualified annuity stretch”:

1. The income will be less than the income using life only annuitization settlement. Because life expectancies of the “uniform table” are longer than standard mortality tables.
2. The beneficiary maintains the tax-deferred status on the unpaid death benefit. Under an annuitization option, funds no longer benefit from tax-deferral.

The new rules establish much smaller required minimum distributions and allow individuals to maintain and maximize the benefits of their annuity by making it possible to “stretch” those mandatory distributions over the life expectancies of themselves and their beneficiaries. The 2001 rules allow an individual to withdraw less, pay fewer taxes and ultimately pass greater wealth on to his or her loved ones.

The ability to leave more funds in an annuity to benefit from future tax-deferred growth and compounding can have a major impact on the future value of the annuity. For example, if an annuity balance of $100,000 is left untouched while earning a 6 percent rate of return for 60 years, it would grow to $3,298,768.99!

**SURRENDER CHARGES**

Almost all deferred annuities have surrender charges. These charges are assessed during the early years of a contract if the owner liquidates or surrenders the annuity before the insurer has had an opportunity to recover the cost of issuing the contract. In addition to recovering issuing costs, the surrender charges also provide some protection against the risk that increasing interest rates will result in contract owners surrendering their annuity contracts prematurely, forcing the insurer to liquidate its underlying investments at an inappropriate time. Surrender charges help offset the potential loss in the insurer’s portfolio if interest rates escalate after a contract owner purchases the annuity.

The penalty is usually expressed as a percentage and assessed against the premium deposited or the account value.

<table>
<thead>
<tr>
<th>Example Of Surrender Charge Schedule</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>YEAR</strong></td>
</tr>
<tr>
<td>SURRENDER CHARGE</td>
</tr>
</tbody>
</table>

Interest rates, bonuses and commissions all have an effect on surrender charges.

- **Higher interest rates** usually mean higher or longer surrender charges.
- **Larger bonuses** usually mean higher or longer surrender charges.
- **Higher commissions** usually mean higher or longer surrender charges.

**Notice of Surrender Charges**
A concern with respect to sales to senior citizens is that they may not fully understand, or that an agent failed to fully explain, that their access to contract cash values may be subject to fees called surrender charges. To be sure that consumers are aware of these limits on liquidity, any individual annuity contract that contains a surrender charge period should disclose to the client:

- the applicable surrender charge period; and
- any and all penalties associated with surrender of the contract.

**Annual Statement Information**

Insurers normally furnish their annuity contract owners with annual statements concerning their contracts. When these annual statements are provided to a senior citizen, they must include the contract’s current:

- accumulation value; and
- cash surrender value.

**SURRENDER CHARGES IN FLEXIBLE PREMIUM ANNUITIES**

Some flexible premium annuities incur a new surrender schedule for each additional deposit. Because they no longer have an income from employment, seniors may need to access an annuity sooner than working-aged adults. Therefore, annuities sold to seniors should not subject additional deposits to new surrender charges.

**SURRENDER CHARGES AT DEATH**

If death occurs during the surrender period, some contracts waive surrender charges and some do not unless the beneficiary takes the proceeds over a five-year distribution.

Agents who sell annuities to seniors need to exercise full disclosure. Agents need to fully explain how a surrender charge would impact the death benefit if heirs elect not to take the distribution over five years. Insurers assess these surrender charges in three ways:

1. Account value
2. Premium deposit
3. Loss of interest

**Account Value and Premium Deposit Methods**

The *account value method* uses a fee structure based on a percentage of the full accumulated account value at the time of surrender, whereas the *premium deposit method* is based on a percentage of the premium or premiums that the contract owner deposited into the contract.

- With the premium deposit method, the surrender charge percentage is high in the initial years, but reduces over time to zero.
- With the account value method, surrender charges that disappear after a certain number of years, but the percentage is fixed at 4 percent. This information can be useful when comparing one contract to another.

Agents should review the provisions of the contracts they sell to determine whether or not they contain surrender charges and what type and fully disclose them to buyers.

**Loss of Interest**

With this type of surrender charge, the contract owner is penalized by a loss of interest over some period of time, usually six months to one year. Loss of interest surrender charges are found on many of the certificate annuities, which creates a close parallel to a bank CD, which typically expresses premature withdrawal penalties as a loss of interest.

<table>
<thead>
<tr>
<th>Surrender charges by year</th>
<th>Premium Deposit Method</th>
<th>Account Value Method</th>
<th>Loss of Interest Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>7%, 6%, 5%, 4%, 3%, 2%, 1%, 0%</td>
<td>4%, 4%, 4%, 4%, 4%, 4%, 0%</td>
<td>Six months’ loss of interest</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Basis of surrender charge:</th>
<th>Percentage of premium</th>
<th>Percentage of accumulated value</th>
<th>Annual Interest</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Amount of surrender charge:</th>
<th>Year 1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8+</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$7,000</td>
<td>$6,000</td>
<td>$5,000</td>
<td>$4,000</td>
<td>$3,000</td>
<td>$2,000</td>
<td>$1,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

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This example assumes an initial deposit of $100,000 and an 8 percent rate.

The charge is made against the value of the investment when the annuity is surrendered, and its purpose of the surrender charge is to discourage a short-term investment by the purchaser. For that reason, an annuity should always be considered a long-term investment.

**MARKET VALUE ADJUSTMENTS (MVAS)**

Some annuity contracts have a market value adjustment feature. If interest rates are different when the annuity is surrendered than when it was purchased, a market value adjustment may make the cash surrender value higher or lower. Since the contract owner and the insurance company share this risk, an annuity with an MVA feature may credit a higher rate than an annuity without that feature. The MVA can be positive or negative.

**ANNUITY FEES AND EXPENSES**

Just like other investments annuities have fees and expenses. Costs vary from product line to product line and company to company, and that variable annuities have more features than fixed annuities, so fees and expenses within a variable annuity are generally higher than those found in fixed annuities. A list of the types of fees for annuities is as follows:

The fees or charges that are often incurred in annuities, particularly in variable annuities, include:

- **Investment Management Fees.** These fees run from a low of about 0.25 percent to a high of about 1 percent
- **Administration Expense and Mortality Risk Charge.** This charge ranges from a low of about 0.5 percent to a high of about 1.3 percent.
- **Annual Maintenance Charge.** This charge typically ranges from $0 to $100.
- **Charge Per Fund Exchange.** This charge generally ranges from $0 to $10, but most funds will permit a limited number of charge-free exchanges per year.
- **Maximum Surrender Charge.** Surrender charges vary by company and policy and generally phase-out over a number of years. If the charge is lower, the phase-out range tends to be longer. For example, typical charges and phase-out periods are 5 percent of premium decreasing to 0 percent over 10 years or 8 percent of premium decreasing to 0 percent over 7 years.

**PREMIUM TAXES**

Several states impose taxes on the annuity premiums that an insurance company collects. However, in most of those states, annuities funding qualified plans are exempt from those taxes. Premium taxes range from .5% to 3.5%, depending on the state.

The significance of premium taxes to contract owners is that they ultimately bear the cost. The method of assessing premium taxes should be covered in an annuity contract and should also be explained in the sales presentation.

**WITHDRAWAL PRIVILEGE PROVISIONS**

Annuities are designed to be long-term investments, however, to compete with other investments, insurers needed to provide some liquidity during the accumulation period of the annuity. Insurers usually allow policyholders to withdraw a portion of the annuity's value free of surrender charges. The amount available differs by

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contract, but they usually fall into one of three “Free” withdrawal types:

- Interest earnings; or
- A percentage of premium deposited; or
- A percentage of the annuity’s value

The “free” amount is typically accessible each year.

If a larger amount is withdrawn, it may be subject to withdrawal charges. Clients may lose any interest above the minimum guaranteed rate on the amount withdrawn. Some annuities waive withdrawal charges in certain situations, such as death, confinement in a nursing home or terminal illness.

**Tax Penalties for Withdrawal**

Even though the withdrawal may be free of surrender charges, tax penalties may still apply. The federal government may impose tax penalties on interest income withdrawn before age 59½. If the annuity is a tax-deferred investment. All interest income is taxable as ordinary income at withdrawal.

**Six Ways to Avoid the Ten Percent Excise Tax Penalty**

There are certain circumstances where the ten percent excise penalty may be avoided:

- Disability of taxpayer;
- Distribution from a pre-8/14/82 annuity;
- Death of owner (but death of annuitant for annuities issued before 4/23/87);
- Payment from an immediate annuity where benefits commence within one year of purchase;
- Payment from a structured settlement; and
- Substantially equal payments over taxpayer's life expectancy.

**SYSTEMATIC WITHDRAWALS**

Some individuals do not wish to give up the control over their capital that annuitization entails. For these individuals, systematic withdrawal plans provide a way to obtain a regular income from their annuity fund. Although the amounts withdrawn are not subject to favorable tax treatment, interest continues to be credited to the annuity fund on a tax-deferred basis. And although the income stream is not guaranteed to last for the individual's lifetime, the fund remains within the individual's control. And the individual still has the option of annuitizing the fund if he or she should wish to do so at some point in the future.

Individuals needn't make an all-or-nothing decision regarding annuitization. They can guarantee themselves a certain level of income for life and still keep some capital fully under their control by annuitizing only a portion of their annuity fund. They can then withdraw money from the nonconverted portion of the fund from time to time as necessary or obtain regular income from it under a systematic withdrawal. In either case, the possibility remains of converting that portion of the fund, or just another part of it, to a guaranteed lifetime income stream at some point in the future.

**Annuitization Payout Options**

Annuitization is the process of converting the lump sum in an annuity into an income stream. There are several annuitization options to select from. The most popular are listed below:

- **Life Only** - Payments continue for life and end upon the death of the annuitant with no refund. The risk with this option is that they could die before receiving the full accumulated value of the investment.
- **Life with period certain** - With this option equal payments are made throughout the lifetime or to the beneficiary for a guaranteed minimum period of time.
- **Joint and Survivor** – This payout option provides for payments over the lives of two individuals and can also be combined with period certain options.
- **Installment Refund** - Payments continue for life. However, if the annuitant dies before the initial deposit is recovered, payments continue to the beneficiary until the balance has been recovered.
- **Cash Refund** - Payments continue for life. However, if the annuitant dies before the initial deposit is recovered, the beneficiary receives the balance as a lump sum.
- **Period Certain** - Payments continue for a selected period either to the annuitant or their beneficiary.
- **Fixed period** – The owner decides how many years they want to receive income payments and the insurer determines the amount of each income payment.
- **Fixed amount** – The owner decides how much the income payments are to be and
the insurer will calculate how long the payments last.

Annuities have the unique capability to guarantee an income that will last as long as someone lives. Today's ever extending lifespans make such a guarantee a more significant consideration than ever. The longer people can be expected to live after retirement, the more crucial it is to ensure that they will have adequate income over that entire period.

Some individuals are reluctant to annuitize their retirement fund because in the event they died prematurely, they would have paid a large premium and received only a relatively small number of payments in return. For these individuals, period certain options can ensure that the annuity will continue to make payments to a beneficiary for the balance of the certain period, even if the annuitant dies before that time. Alternatively, a refund option can be chosen which will ensure that a beneficiary will enjoy the balance of the original amount paid for the annuity in the event that the annuitant dies before receiving payments totaling that amount.

However, such guarantees come at a price. If the company is obligated to continue payments for a given period in the event an individual dies soon after premium conversion, the premiums of individuals who die prior to reaching life expectancy will no longer completely cover the payments that must be made to individuals who outlive their life expectancy. To make up for the deficiency, annuity payment amounts are smaller when guarantees are built into the payment option.

The following table illustrates the different benefit payments that a $100,000 annuity fund would generate, depending on the payout option selected. As you can see, the more guarantees the option provides, the smaller the monthly payment.

<table>
<thead>
<tr>
<th>Payout Option</th>
<th>Amount of Monthly Payment*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life only</td>
<td>$789</td>
</tr>
<tr>
<td>Life only with 10-year certain</td>
<td>$737</td>
</tr>
<tr>
<td>Joint life and 50 percent survivor</td>
<td>$708</td>
</tr>
<tr>
<td>Joint life and 100 percent survivor</td>
<td>$664</td>
</tr>
<tr>
<td>Joint life and 50 percent survivor with 10-year certain</td>
<td>$698</td>
</tr>
<tr>
<td>Joint life and 100 percent survivor with 10-year certain</td>
<td>$663</td>
</tr>
<tr>
<td>5-year certain</td>
<td>$1,802</td>
</tr>
<tr>
<td>10-year certain</td>
<td>$1,077</td>
</tr>
</tbody>
</table>

*Assumes the annuitant is a male, age 60, and his spouse/survivor is also 60 years old. The annuitant’s life expectancy is 17.5 years; joint life expectancy is 25.7 years.
FIXED ANNUITIES

Because fixed annuities typically attract people with low risk tolerance, the insurance company’s approach to managing fixed annuity investments is conservative. Money deposited into fixed annuities is held in the general account of the insurance company where the insurance company assumes the investment risk. The general account is a diversified investment portfolio consisting of bonds, fixed income securities and real estate.

Fixed annuities provide a guaranteed rate of return on the investment and a fixed, stable income in its payout phase. The insurer, not the insured, takes the investment risk. This steady retirement income is, however, subject to inflation.

- Fixed annuities invest in low-risk assets.
- Fixed annuities provide a relatively stable rate of return with low level risk comparable to a CD.
- They are considered a low-risk investment.

DEATH BENEFIT

One feature annuities offer that is absent from other investments is a guaranteed death benefit. The death benefit payable to the beneficiary of a deferred annuity prior to the annuity starting date is usually equal to the greater of either:

1. the total premium paid for the annuity to date, minus any withdrawals, or
2. the current accumulated value of the annuity fund.

If death occurs after a contract’s maturity date and after annuitized income payments have begun, payments will continue (or cease) as provided for under the distribution option in effect.

Generally, no surrender charges or market value adjustments are applied in determining the amount of the death benefit.

Owner’s Death

Federal tax law requires that certain distributions be made from an annuity in the event that any owner of the contract dies. If the owner of the contract is not a natural person, the annuitant will be considered the owner for the purposes of the rule, and a change of annuitant is treated the same as the death of an owner for tax purposes.

Required distributions are as follows:

- If an owner dies after the annuity starting date, any remaining payments that are due under the annuity must continue to be made at least as quickly as payments were being made prior to the death of the owner.
- If the owner dies before the annuity starting date, the entire value of the annuity must either be distributed within five years of the date of the owner’s death, or the value of the annuity must be annuitized within one year of the date of the owner’s death.
- **Lump-sum payout** – distribution of the entire account by the end of the calendar year following the year in which death occurs. Gain taxed accordingly.
- **Five-year rule** – requires that the beneficiary distribute the entire account by the end of the calendar year that contains the fifth anniversary of death. Gain taxed as distributions occur.

There is one exception to the rule requiring distributions in the event of an owner’s death. If the beneficiary of the annuity is the surviving spouse of the deceased owner, then the surviving spouse is permitted to become the owner. Distributions will not be required until the surviving spouse’s subsequent death.

Other than surrender charges or charges for special features, the fees and charges for fixed annuities are included (or bundled) in the overall price and interest crediting structure of the product.

HOW THE INTEREST RATE IS DETERMINED FOR A FIXED ANNUITY

Annual

The traditional deferred annuity offers an initial interest rate which is guaranteed for a period shorter than the term of the annuity itself. Most traditional annuities guarantee the initial interest rate for one year, although some products may offer
a longer initial rate guarantee, like three years. The insurer re-declares a new interest rate each anniversary. There is a stated minimum guaranteed interest rate that the renewal rate may never fall below.

During the accumulation period, money (less any applicable charges) earns interest at rates that change from year to year. Some annuity contracts apply different interest rates to each premium paid or to premiums paid during different time periods.

THE MULTI-YEAR GUARANTEE ANNUITY

Multi-year guarantee annuities are designed with an interest rate that is guaranteed for the full-term of the annuity. Since a client can accurately predict the value of the annuity throughout the life of the contract, they are especially useful for reaching a specific value at some time in the future such as retirement.

METHODS OF CREDITING EARNINGS

When an insurance company invests fixed annuity funds, it uses conservative investments like high quality bonds and mortgages. When the interest rate period ends, the insurance re-declares a new rate using one of two methods:

PORTFOLIO RATES

Portfolio Rate Interest Crediting credits the same interest rate to new and existing policyholders. All annuity monies go into one large pool or portfolio. The total return of that portfolio is used to establish the interest rate for all contract owners who buy that annuity. When it comes to renewal time, the insurer looks at the entire portfolio, regardless of when each individual investor bought his or her contract, and establishes a renewal rate for the entire block.

NEW MONEY RATES

New Money Interest Crediting credits interest by investing annuity funds in many different accounts according to similar interest rate cycles. When the cycle fluctuates, a separate account of investments is then used to capture the annuity funds received during this new environment. The insurer evaluates each of the accounts at renewal time to establish the renewal rate by looking at the cash flows from the underlying investments, reinvestment of the undistributed cash flows and the market value of the investment portfolio, as well as many other factors. The renewal rate of current policy holders will most likely be different than the interest rates offered to new policyholders.

MINIMUM GUARANTEED RATE

Fixed annuities have a guaranteed minimum interest rate and a current rate that is higher than the guaranteed minimum. The minimum rate is guaranteed for the life of the annuity. The current rate is guaranteed for a shorter period, usually one year. Annuity owners can expect the current rate to change periodically while the guaranteed minimum rate represents the lowest rate the annuity will earn.

Minimum annuity interest rates reflect, in part, the reserving and nonforfeiture requirements that insurers must meet. In effect, the minimum interest rate provides a guaranteed worst-case scenario relative to a fixed contract's growth. For most fixed annuities, the minimum rate is 3 to 4 percent.

CURRENT INTEREST RATE

The current rate is the rate the company credits to the contract at a particular time. The company will guarantee it not to change for some time period. Current rates offered on annuities vary much more widely and frequently than guaranteed minimum rates.
### Low interest rate environment impact on interest rates

<table>
<thead>
<tr>
<th></th>
<th>In a Rising Rate Environment…</th>
<th>In a Falling Rate Environment…</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Initial Period</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Market rate</td>
<td>7.0%</td>
<td>Market rate</td>
</tr>
<tr>
<td></td>
<td></td>
<td>9.0%</td>
</tr>
<tr>
<td>Initial annuity rate</td>
<td>5.0%</td>
<td>Initial annuity rate</td>
</tr>
<tr>
<td></td>
<td></td>
<td>7.0%</td>
</tr>
<tr>
<td>Competitor’s rate</td>
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<td>Competitor’s rate</td>
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<tr>
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<td>Sales</td>
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<td></td>
<td>$100 million</td>
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<tr>
<td><strong>1 year later</strong></td>
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<td></td>
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<tr>
<td>Market rate</td>
<td>9.0%</td>
<td>Market rate</td>
</tr>
<tr>
<td>Annuity rate*</td>
<td>6.0%</td>
<td>Annuity rate*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6.0%</td>
</tr>
<tr>
<td>Competitor’s rate</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>5.0%</td>
</tr>
<tr>
<td>Company sales</td>
<td>$100 million</td>
<td>Company sales</td>
</tr>
<tr>
<td></td>
<td>$100 million</td>
<td>$100 million</td>
</tr>
</tbody>
</table>

*This is the renewal rate for existing business as well as the initial rate for new business. It is determined by weighting half of the portfolio at 7 percent and half at 5 percent (5 percent derived from market rate minus spread).*
VARIABLE ANNUITIES

Variable annuities generate returns that fluctuate in value over time, based on the performance of the underlying portfolios they are invested in. Since the stock market has generally outpaced inflation, variable annuities are useful in protecting against the effects of inflation.

A variable annuity is designed to take advantage of the investment opportunities found in the stock market. Like other deferred annuities, variable annuities enable clients to accumulate money tax-deferred in order to provide an income at a later date. Variable annuities offer the choice of several investment divisions such as stocks, bonds, and money market funds, which can cause the rate of return to fluctuate with market conditions. The amount of money that the insurance company will pay upon annuitization depends on which investments selected and how they performed during the accumulation period.

With a variable annuity, the owner, not the insurance company, assumes the investment risk. There is no guaranteed minimum return. The value of the annuity depends on the performance of its underlying investments.

Because the owner bears the investment risk, variable annuities are regulated as securities. In addition to a state insurance license, sales representatives must have the appropriate state and federal securities licenses to sell variable annuities and must comply with state and federal securities regulations in their variable annuity sales and service activities.

Variable annuities are sometimes used by investors who like to trade (buy and sell) mutual funds often and who do not need their money for many years to come, especially those in a very high tax bracket now who expect to be in a much lower tax bracket at retirement.

Generally, variable annuities have two phases:

1. The "accumulation" phase when investor contributions - premiums - are allocated among investment portfolios - subaccounts - and earnings accumulate; and
2. The "distribution" phase when the money is withdrawn as a lump sum or through various annuity payment options.

ACCUMULATION UNITS

Premium dollars, deposited into a VA contract, are used to buy accumulation units based on the net asset value of the separate account funds at the time of purchase. A contract's accumulation unit has a given value when the contract is issued, and the initial premium deposit buys accumulation units at that price. For example, a $5,000 premium deposit in a VA in which the units are valued at $5 would purchase 1,000 accumulation units. The units represent the purchaser's ownership of the particular subaccount or subaccounts in which his or her premiums are invested. From that point on, the value of an accumulation unit fluctuates in response to the underlying funds in which the contract's values are invested; the insurer regularly (usually daily) revalues the units accordingly. Each revaluation reflects the gains or losses the investment account experienced. After deductions are taken for expenses and fees, future premium deposits are applied to purchase additional accumulation units at their current value. The annuity accumulation unit value (AUV) is usually calculated daily.

VARIABLE ANNUITY INCOME AND LIQUIDITY OPTIONS

FREE WITHDRAWALS

Most variable annuities provide for withdrawal of a specified amount free of charge. Withdrawals in excess of the amount specified are possible but, in the early years of the contract, may trigger surrender charges. They may also encounter a "market value adjustment" (MVA).

While a variable annuity's free withdrawal provision allows access to a portion of the contract's values without a surrender charge, any withdrawals still are subject to income tax and possibly a penalty if taken before age 59½.

VARIABLE ANNUITIZATION

Variable annuities can also be annuitized. Variable annuitization not only provides a guaranteed life income but can also provide the ability to respond to inflation. Like the cash values of variable annuities themselves, the income stream from variable settlement options also fluctuates.
Variable annuity contract owners have the option of annuitization; converting the funds in their annuities to income streams, guaranteed for a certain period of time, for life or for a combination of the two.

Most companies offer several annuity options, based primarily on how long the income will last. First, the insurance company converts accumulation units to "annuity units", which result in payouts that are partly a tax-free return of principal and partly taxable earnings. Meanwhile, the undistributed portion of the investment continues to compound, tax-deferred.

Variable annuitization involves a contract owner selecting an assumed interest or investment rate, known as the AIR. Based on that rate and the payment period, the carrier determines the initial (typically monthly) payment, then converts the payment into units based on the annuity unit value at the time of the initial payment. Subsequent distributions are of the same number of annuity units, but the value of the units varies, based on the performance of the underlying separate account.

Often the contract will offer a limited selection of AIRs, such as 3%, 5%, or 7%. Choosing the higher rate assumption will provide the highest initial income. But it will decrease the fastest if the net returns of the subaccounts fail to keep pace with the selected return. Determining which assumed interest rate to use depends on the risk tolerance of the client. A more conservative client will usually choose a more conservative AIR, hoping that the monthly income will go up over time. A more aggressive client will choose a higher AIR expecting that the income stream will stay high.

Because the variable annuity houses fixed and separate accounts within the same product, the annuity owner has an option to create a mixture of fixed payments and variable payments. The contract owner allocates a dollar amount to the fixed account that will result in a guaranteed fixed payment stream for the term selected by the contract owner with the balance annuitized in the separate account.

Once annuitized, each payment is structured as a partial return of principal and part interest. Only the interest portion of the payment is taxable. In addition, clients can annuitize over their lifetime before age 59½ and the regular payments will not be subject to a tax penalty. Clients should consult their financial and/or tax advisor before deciding to annuitize.

Variable annuities are designed to be long-term investments, to meet retirement and other long-range goals. Variable annuities are not suitable for meeting short-term goals because substantial taxes and insurance company charges may apply if the money is withdrawn early. Variable annuities also involve investment risks, just as mutual funds do.

Variable options

Most variable annuities provide a range of options, from various types of stock and bond funds to money market funds and even a fixed account option. Premiums allocated to the fixed account option are guaranteed against investment risk and are credited with a guaranteed minimum return.

SUBACCOUNTS AND GENERAL ACCOUNT

Deposits made into variable annuities are invested into a separate account, divided into subaccounts. Subaccounts consist primarily of investments in stocks, bonds, mutual funds, and T-bills. Agents must understand that the investment risk is assumed by the investor.

Subaccounts

- Annuitant bears investment risk
- Consists of stocks, bond, mutual funds, etc.
- Sub-account assets are protected from potential claims of the insurance company's creditors

Many companies offering variable annuities also offer fixed account options to compliment the subaccounts. Money in the fixed account is held in the general account of the insurance company. The general account is a diversified investment portfolio that is used for investments in the fixed interest account. Unlike the subaccounts, the investment risk associated with money in the general account is assumed by the insurance company.

General Account

- Insurer bears investment risk
- Consists of fixed income securities and real estate
- General account assets are not protected from potential claims of insurance company's creditors
TYPES OF VARIABLE ANNUITY SUBACCOUNTS

Today, variable annuity buyers have many investment options for the allocation of their contract funds, with more being introduced each day. This has made it possible to choose investment options that match a buyer's goals, objectives and risk tolerance.

The majority of variable annuities let clients choose among portfolios of stocks, bonds and money market instruments. They allocate money to purchase accumulation units in different portfolios, depending upon how aggressive or conservative they wish to be.

Clients choose the portfolios in which they will invest from among those offered. The insurance company backing the annuity develops a relationship with a professional money manager, whose experts decide which specific stocks and bonds will be a part of each portfolio. In some newer variable annuities, clients can take advantage of more than one expert money manager, allowing even more flexibility in structuring their investment.

Owners are permitted to make transfers, or exchanges, of their funds among the available investment options, subject to some restrictions, such as frequency of transfers, number of transfers per year, minimum dollar amount or percentage of sub-account value transferred, or minimum dollar amount or percentage of value remaining in the sub-account.

**EQUITY-BASED**

**Growth Stock Subaccount**

The investment of a growth stock subaccount is focused primarily on investments in common stock of companies that have above average growth potential. Growth stock subaccounts could be further specialized by targeting large cap, midcap, and small cap companies. Depending on the objectives, some growth funds are aimed at more aggressive growth while others seek more conservative capital gains, with some dividend distribution to provide limited income. Some funds even target smaller companies for better growth.

**Value Stock Subaccount**

The objective of a value stock subaccount is to invest the majority of the assets in common stocks of companies that are under-valued in the market. Value stocks often perform well in periods where growth stocks perform poorly.

**Other Subaccounts**

Many other types of subaccounts are available in the variable annuity market of today.

**GLOBAL SUBACCOUNTS**

Global and international accounts are very popular today. Global funds seek to buy debt and equity issues from other prospering or developing nations, in addition to those of the United States. A variation of these funds is the international fund, which invests all of its money outside of the United States. Many advisors believe that the diversification global and international funds offer will be very desirable for long-term investors. Contract owners should be aware that most global and international funds impose higher than average management fees and expenses.

**PRECIOUS METALS SUBACCOUNTS**

Precious metals accounts are comprised of equity and debt instruments of companies involved in gold and other precious metals.

**SOCIAL AND ENVIRONMENTAL SUBACCOUNTS**

Social and environmental funds invest in companies that are socially or environmentally responsible.

**INDEX SUBACCOUNTS**

The index fund attempts to "mirror" a major index-such as the S&P 500 and match its gains and losses. Some insurers include index options in their general accounts, providing both index returns and minimum guarantees of interest.
Risk-based

Money Market Subaccount

The objective of this subaccount is to provide the highest current return possible while preserving principle and maintaining liquidity. A money-market fund invests in very secure, short-term investments. Typically, maturities do not exceed one year. The fund usually consists of CDs, Treasury bills and commercial paper, which are short-term notes usually issued by large, financially secure corporations. Because of the short duration of the portfolios, interest rates on money-market funds usually are low when compared to other long-term investments.

Agents, should be aware that, although funds in this subaccount may preserve principle, surrender charges and taxes diminish the liquidity.

Bond Subaccount

The objective of a bond subaccount is to invest the majority of funds in corporate bonds or other debt investments including government or corporate bonds, both foreign and domestic. In a conservative bond fund versus a high yield bond fund, the underlying quality of the bonds will be strong.

Bond accounts tend to attract individuals seeking income from the variable annuity. Bond funds invest exclusively or primarily in debt securities.

Bond funds are much more subject to interest rate risk than stock and growth funds. As interest rates rise, the stock market may or may not respond negatively, but the value of a bond fund goes down and corresponding income is more susceptible to inflation.

High Yield Bond Subaccount

The investment objective of a high-yield bond subaccount would differ from a normal bond subaccount, since the underlying investments are lower rated bonds, and thus more risky. High risk bond funds purchase lower grade debt security than a more traditional bond fund, which may buy higher quality, lower yielding bonds.

Insurance companies offering variable annuities usually offer a fixed interest option. The objective of the fixed rate subaccount is to generate conservative and safe returns. The fixed rate subaccount offers a fixed interest rate that is guaranteed for one or more years. The fixed account in a variable annuity may also provide a minimum guaranteed interest rate.

CHARGES AND FEES

Mortality and Expense Charges

The first fee typically imposed by an annuity will be what's known in the industry as a "mortality and expense" (M&E) charge. This fee pays for the insurance guarantee, commissions, selling, and administrative expenses of the contract. In general, these fees in a variable annuity will be charged as a percentage of the average value of the investment. According to the National Association of Variable Annuities (NAVA), the industry average M&E in 1997 was 1.15%. In a fixed annuity, these charges are usually incorporated in the insurance company's determination of the periodic interest rate or the annuity payment amount during the distribution phase.

Some of the newer approaches to defining and periodically resetting the death benefit under a variable annuity contract are more expensive for the insurer. Consequently, the contracts that offer these benefits assess an additional mortality charge. Some carriers allow each buyer to choose between the traditional death benefit reset and the enhanced benefit reset at the higher cost.

Keep in mind that the mortality and expense charge, as well as the administrative service charges, are assessed only against the funds held in the separate account; they never are assessed against funds held in the general account.

Mortality and expense risk charges are computed on and deducted from the net value of the separate account each day, but they are usually expressed in an annual percentage. It is usually shown as a combined charge, though many companies also show the breakdown into the mortality and expense elements. The combined percentages vary widely, ranging from about .5% for some companies to over 2% for others.

The company's mortality risk comes from two sources. One is the guaranteed lifetime payment options in the contract. The payment amounts are based on mortality statistics, but there is a chance that annuitants as a whole will live longer than the statistics indicate, making those lifetime guarantees more expensive to the company.
The other source of mortality risk is the death benefit that the company guarantees to the beneficiary in the event of the owner's death prior to the annuity starting date. It is possible for the death benefit guaranteed by the company to be greater than the value of the separate account at the time of the owner's death. The mortality risk charge compensates the company for that possibility.

The source of expense risk is that it may cost more to administer and distribute the contracts than the company anticipated. The company guarantees that its mortality and expense risk charges will not increase.

**OTHER FEES**

In addition to the mortality and expense charge, variable annuity contracts typically contain fees such as policy administration charges and investment management fees. The fees are listed and disclosed in full detail in the prospectus. These are some of the more common fees in addition to mortality and expense fees:

**ADMINISTRATION CHARGES**

An *administrative service charge* usually is expressed as a percentage of the funds invested in the separate accounts. It covers the cost of transferring funds from one separate account option to other separate account options or to the general account fixed option. It also covers the issuance of quarterly, semiannual or annual statements, depending on the insurer. Finally, it covers the costs of tracking deposits and the issuance of confirmations when monies are received or withdrawals are made. (This includes the processing of loans for variable annuities that are used to fund qualified plans such as 403(b), 401(k) or 401(a) plans.) This fee is calculated and deducted daily on an annualized basis from all monies in the separate/variable accounts within the contract. Most VA contracts stipulate that this fee will not increase.

The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps $25 or $30 per year) or as a percentage of the account value (typically in the range of 0.15% per year).

**Contract Maintenance Charge**

A yearly *maintenance charge* commonly is assessed to cover the administrative expenses associated with the variable annuity contract. This charge, usually applied at each contract anniversary date and upon surrender of the contract, covers the cost of issuing the policy, as well as other administrative costs. Some insurers waive this charge if the contract value is greater than a specified level.

Many companies assess a policy maintenance fee to pay for the expenses of maintaining the contract on their books. This is often a flat dollar amount of between $25 and $40, assessed once each year. This charge may also be deducted on a quarterly basis from each separate account investment option to which the owner has allocated funds.

**Management Fees**

Management fees on subaccounts are assessed by variable annuities, and they are the same as an investment manager’s fees in a mutual fund. These fees will vary depending on the various subaccount options within the annuity. In general, they will be somewhat less than those charged by a managed mutual fund within the same investment category—though not necessarily. According to NAVA, the 1997 industry average for subaccount management fees was 82 basis points, or 0.82%.

Management fees are the costs of managing a portfolio in a separate account. Management fees vary widely, depending on the type of fund. The range is generally from 25 percent of assets under management for a money-market fund to more than 1 percent for some global or international funds. The difference reflects the level of expertise needed to manage the fund and the higher costs associated with the start-up of any fund.

The management fees and expense charges are *not* assessed directly to the contract owner. These charges are assessed against the subaccount values and are subtracted before calculating the accumulation unit value for the subaccount. Consequently, they affect the underlying fund’s performance.

**Fees for Special Features**

Charges for special features, such as a:
- Stepped-up death benefits;
- Guaranteed minimum income benefits;
- Long-term care insurance; or
- Principal protection.

A description of the charges can be found in the prospectus of any variable annuity.

**Surrender Charges**

With most variable annuities currently marketed, rather than deducting the sales charge up-front. 100 percent of a contract owner's funds are available for immediate investment. In return, to offset commissions that insurance companies pay to the agents who sell VA contracts, the companies assess surrender charges to contract owners who liquidate their contracts during the first several years. These surrender charges also may be called *contingent deferred sales charges*. The charge is assessed against any withdrawal that does not meet the contract's free withdrawal provision.

Surrender charges in variable annuities do not usually apply at death, during the free-look, or to penalty-free withdrawals. When surrender charges are applied, the charge is made against premium contributions instead of account values.

The length and amount of surrender charges is important to consider when evaluating suitability. Selling an annuity with surrender charges that last longer than the contract owner's anticipated need for funds is not suitable.

**DOLLAR COST AVERAGING**

*Dollar cost averaging (DCA)* is a method of purchasing accumulation units within a variable annuity by making regular, level investments over a period of time. By using DCA, the contract owner can keep his or her average cost below the market. With the same amount invested on a regular schedule when the market price is higher, fewer shares will be purchased. When the market price is lower, more shares will be purchased.

With deferred annuities, dollar cost averaging during the accumulation phase is virtually automatic. Where the deposit is a lump sum, dollar cost averaging is accomplished by allowing a portion of the investment to earn a fixed interest rate and systematically transferring portions into sub-accounts each month.

Dollar cost averaging does not offer a guarantee of gain or a guarantee against loss but over time it helps to average out the highs and lows in the market.

**ASSET ALLOCATION**

Asset allocation is a process through which an investor allocates money across different asset classes, like stocks, bonds, cash and real estate. The process reflects an investor's personal attitudes about investing by addressing a variety of factors. When the contract owner elects this option, the company's asset managers move the money for the contract owner and change the allocation percentage for future deposits. The contract owner can designate part or all of his or her account to be moved and spread as the money manager sees fit.

**Keys to Asset Allocation:**

- Define Goals
- Gauge Risk Tolerance
- Look at the Big Picture
- Match Products to the Profile
- Choose a Mix that Suits Clients Needs

Through diversification, clients can help "spread" their risk by holding products that invest in different asset classes—equities, fixed-income, real estate, money market funds, and guaranteed accounts. Diversification helps offset the volatility of a single investment and take advantage of the earning potential of several.

The key is asset allocation—choosing and maintaining the right combination of investments to reach clients goals, based on their risk tolerance and time horizon.
### Asset Allocation Models

<table>
<thead>
<tr>
<th>Investor Profile</th>
<th>Investment Objective</th>
<th>Asset Class Composition</th>
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<tbody>
<tr>
<td>Conservative</td>
<td>Preservation of Capital</td>
<td>Fixed Income: 80%</td>
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<td>Moderate Growth</td>
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<td>Equity: 41%</td>
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<tr>
<td>Moderate</td>
<td>Steady Growth In Asset Values</td>
<td>Fixed Income: 41%</td>
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<td></td>
<td></td>
<td>Equity: 59%</td>
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</table>
Moderate-Aggressive | Moderately High Growth In Asset Value
---|---
| | 
**Fixed Income:** 24%
**Equity:** 76%

Aggressive | High Growth In Asset Value
---|---
| | 
**Fixed Income:** 6%
**Equity:** 96%

---

**Subaccount Reallocation**

An investor's financial objectives often change over time as well. Working-aged adults are usually focused on aggressive growth during their peak earnings years. As they approach retirement, however, they become more conservative. Investors in variable annuities have the flexibility to reallocate funds in subaccounts. Most variable annuity contracts allow for twelve or more transfers per year without charge.

**Bonus Credits**

In an attempt to attract investors, many variable annuities now offer bonus credits that can add a specified percentage to the amount invested in the variable annuity, generally ranging from 1% to 5% for each premium payment made. Bonus credits, however, are usually not free. In order to fund them, insurance companies typically impose high mortality and expense charges and lengthy surrender charge periods. The more bonus interest offered, the higher or longer the surrender charge will be.

Bonuses are not inherently bad, but the buyer must understand the necessary trade-off he or she accepts when purchasing a bonus annuity. The agent must advise the client to consider whether the bonus is worth more than its cost. The answer rests on a number of factors:

- Amount of the bonus credit
- Amount of the increased charges
- How long the client plans to hold the annuity contract

In a variable annuity the bonus may be accompanied with either a higher surrender charge or an additional percentage charged against the account values. Depending on how long the client holds the contract, the bonus annuity with increased annual charges may produce a lower overall account value than a lower priced annuity with no bonus.

The controversy over bonuses is not that they're being offered, but how they're being marketed. Some companies use this feature to pursue Section 1035 exchanges aggressively. The bonus is often
used as an inducement to buy by offsetting any surrender charge that the contract owner faces when surrendering the existing contract. The SEC is investigating this practice. The SEC has issued the following consumer warning:

“If you already own a variable annuity and are thinking of exchanging it for a different annuity with a bonus feature, you should be careful. Even if the surrender period on your current annuity contract has expired, a new surrender period generally will begin when you exchange that contract for a new one. This means that, by exchanging your contract, you will forfeit the ability to withdraw money from your account without incurring substantial surrender charges . . . (and) the charges and other fees may be higher on the annuity with the bonus credit than they were on the annuity that you exchanged.”

Agents who market bonus annuities must avoid unnecessary replacement activity and must diligently disclose the ultimate cost of the bonus to their clients so they can make an informed decision.

Living Benefits Guarantees
A new trend in the VA market are guaranteed living benefits (GLBs). Designed to ensure some minimum contract amounts, these new guarantees generally take one of three forms:

1. Guaranteed minimum account value
2. Guaranteed minimum income benefit
3. Guaranteed minimum income payments

Guaranteed Retirement Income Benefit (GRIB)
One special type of variable annuity is the living benefit annuity, also known as a Guaranteed Retirement Income Benefit. The best living benefit annuities guarantee a minimum return over seven years, or the highest attained value on each anniversary during the surrender period, whichever is greater. In exchange for this living guarantee, the living benefit annuity has a surrender charge, or penalty for early withdrawal, no up-front bonus, and a slightly higher annual fee.

DEATH BENEFIT GUARANTEES
In fixed and equity-indexed annuities, the death benefit is usually the accumulated value or the surrender value. With variable annuities, due to the investment risk of the subaccounts, the death benefit fluctuates and could potentially be far less than the amount invested in the contract.

The guaranteed minimum death benefit is generally the greater of either the total amount of premiums, less withdrawals, or the current value of investments. Agents should carefully read the contract language for the variable annuity chosen to find out exactly what type of death benefit the company offers.

The stepped-up death benefit may also include any premiums paid (minus any withdrawals taken) since that time.

GUARANTEED MINIMUM ACCOUNT VALUE (GMAV)
The guaranteed minimum account value (GMAV) ensures that the contract’s account value will be no less than a specified percentage of premiums paid after a specified number of years, such as 8 or 10. The amount of the guarantee exceeding the account value at the end of the specified period is added to the account value and the contract continues, with or without a new guarantee period. Annuitization is not required to realize this benefit.

GUARANTEED MONTHLY INCOME BENEFIT RIDERS (GMIB)
Regardless of how the subaccounts perform, this rider guarantees a competitive interest rate for the full term of the annuity provided the owner annuitizes upon maturity. This rider can be beneficial for both preretirees and seniors, since it adds a level of safety to the contract.
Guaranteed Minimum Income Benefit (GMIB)

The most common living benefit. The guaranteed minimum income benefit (GMIB) ensures that a minimum amount will be available to convert to annuitized income at rates specified in the contract. Consequently, a minimum income benefit is guaranteed. Risk to the insurer is at least partly managed by making the benefit contingent upon annuitization.

Guaranteed Minimum Income Payments (GMIP)

Guaranteed minimum income payments (GMIPs) ensure that each annuitized income payment the annuitant receives under variable annuitization will never be less than a certain percentage of the first payment. This benefit has been recently added to immediate variable annuities, to help limit the possible fluctuation of monthly variable payments.

Guaranteed Minimum Withdrawal Benefit (GMWB)

Allows for a certain minimum amount that may be withdrawn from the annuity, usually over a set period of time.

### Annuity Comparison Chart

<table>
<thead>
<tr>
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<th>Fixed Annuity</th>
<th>Variable Annuity</th>
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THE EQUITY INDEXED ANNUITY

Equity-indexed annuities offer consumers a potentially higher rate of return than a traditional fixed annuity, but without the downside risk of variable products. Equity-indexed annuities (also known as EIAs) are relatively new. The first equity indexed annuity became available in the early 90’s as a product that allowed consumers to participate in the stock market’s upside without subjecting them to its potential downside. Since their introduction, these products have continued to gain popularity and sales are in the billions of dollars annually.

In California, more than 100 equity-indexed annuities are approved by the Department Of Insurance. The theory behind all indexed annuities is virtually the same - to offer market-linked growth without the associated risk. There are, however, many different designs in the marketplace. This makes it extremely important for agents to thoroughly understand and explain to their client’s contracts they sell.

The equity-indexed annuity is a fixed annuity that credits interest based on changes in a major market index, like the S&P 500. If the index increases, then some or all of that increase in credited to the annuity. If the index decreases, the value of the annuity does not fall. The principal and all previously credited interest is preserved. The least an equity-indexed annuity can earn is 0%.

Equity Index annuities provide a minimum guaranteed interest rate with excess interest crediting based on the movement of an external index. Equity index annuities share the same features as other fixed annuities:

- Tax deferral of interest compounding inside the annuity
- Lifetime income options
- Minimum interest guarantees
- Probate free death benefit if a beneficiary is named
- Interest earnings are often available through free withdrawals
- Regulated by an insurance product, not a security
- Withdrawals subject to IRS “premature distribution” rules
- Surrender charges

The original principal and previously credited interest are not subject to market risk. Even if the index declines the individual would receive no less than their original principal back if they decided to cash in the policy at the end of the surrender period.

THE INDEX

Index annuities may base the crediting of excess interest on movements of the S&P 500, Dow Jones Industrial Average, NASDAQ 100, Russell 2000 or other indices that are also used. Unlike an equity index mutual fund neither dividends nor capital gains are included in the index annuity calculation. No index-linked product is sponsored, endorsed, sold or promoted by any index.

Some companies have developed products with a variety of index options, including a traditional fixed interest rate strategy. By offering variety, the consumer can elect to allocate their deposit between the index options most suited to their needs. For flexibility, products typically allow for re-allocation among the indices each anniversary.

When someone buys an equity-indexed annuity they own an insurance contract. They are not buying shares of any stock or index. Since an equity indexed annuity (EIA) is a fixed annuity it does not require a securities license to sell.

Due to the unique nature of the EIA with its principal protection and index-linked returns, an EIA may be more appealing than standard fixed annuities without the market risk of variable annuities or mutual funds, particularly for those seeking a stable retirement income that can keep up with inflation.

Since the EIA allows for protection of principal in down markets and provides for a zero percent return instead of a negative return during market declines, an EIA is ideal for clients who would like to participate in market returns yet are uncomfortable with market risk. As people age, inflation continues to erode the buying power and savings of clients. Over time, the highest investment returns have resulted from the equity markets. With the uncertainty of the stock market and low interest rates, clients are seeking safe alternatives to provide returns immune from market and inflation risks.
Withdrawal Privileges

Most EIAs offer a 10–20 percent standard withdrawal feature while providing a nursing home or terminal illness waiver that may allow for a substantial or complete withdrawal without penalty. Typically most contracts allow for full contract value without penalty upon death of the annuitant.

INTEREST RATE CREDITING STRATEGIES

An equity-indexed annuity is different from other fixed annuities because of the way it credits interest to the annuity's value. Equity-indexed annuities credit interest using a formula based on changes in the index to which the annuity is linked. The formula decides how the additional interest, if any, is calculated and credited.

The two features that have the greatest effect on the amount of additional interest that may be credited to an equity-indexed annuity are the indexing method and the participation rate. It is important to understand the features and how they work together.

Term

The term index is the period over which index-linked interest is calculated. The interest is credited to the annuity at the end of a term. Terms are generally from one to ten years, with six or seven years being most common. Some annuities offer single terms while others offer multiple, consecutive terms. If the annuity has multiple terms, there will usually be a window at the end of each term, typically 30 days, during which clients may withdraw their money without penalty. For installment premium annuities, the payment of each premium may begin a new term for that premium.

Interest Compounding

It is important to know whether the annuity pays compound or simple interest during a term. While an annuity that pays simple interest may earn less, it may have other desirable features, such as a higher participation rate.

To better understand the mechanics of an equity indexed annuity, agents need to understand the major crediting methods used to calculate index-linked returns in order to evaluate potential returns for a contract owner.

On a traditional fixed annuity, the company declares an interest rate in advance and then credits that interest rate to in-force policies. In contrast, the interest rate credited to an equity-indexed annuity is the result of growth in an index, less fees taken by the insurance company.

If the index goes up, the annuity is credited with at least a portion (from 60% to 110%, depending on the contract) of the increase. If the index goes down, however, neither the original principal nor any interest previously credited to the annuity is reduced.

The “indexing method” means the approach used to measure the amount of change, if any, in the index. There are several methods for determining the change in the relevant index over the period of the annuity. These varying methods impact the calculation of the amount of interest to be credited to the contract based on a change in the index. Some of the most common indexing methods include Point-to-Point, Monthly Averaged and High Water Mark.

THE MONTHLY AVERAGING METHOD

The monthly averaging method takes the index value each month to arrive at an annual index average. The index average for the year is then compared to the index value at the start of the year. If the result is positive, the insurance company will then apply the participation rate, cap rate, and/or spread yield.

For example, the ending index value of a monthly averaging method would be calculated as the last 12 monthly anniversary values added and divided by 12 to create an average annual value. In this case, averaging protects the contract holder from sudden declines in the index.

This method helps prevent the risk of having no growth during years when the index may be volatile or suddenly turn downward just prior to the anniversary. The averaging method works best in volatile markets over a limited period of time.

The Point-To-Point Method

With this type of product, the value of the index to which the annuity is linked is marked at the time the contract is purchased and again at the end of its term. The difference in the index value between
these two points is the basis for the amount of interest that will be credited to the annuity. The two most common versions of this strategy are annual point-to-point and long-term point-to-point.

The major disadvantage of the point-to-point method is the risk that the index might be at a low point on the date the second point is recorded, resulting in the loss of unrealized index gains if the index sinks just prior to the second end point.

In conditions where the index is either volatile or in a declining trend, equity-indexed annuities using a monthly averaging method may be more suitable than a point-to-point strategy. The point-to-point term method works best in upward-trending markets over time, whereas the point-to-point with annual reset tends to work best in uncertain and volatile markets.

**Annual point to point**

An annual point-to-point would measure the index on the issue date and again one year later. With this option gains are credited to the annuity annually and the process of measuring index growth starts again each year.

**Long term point to point**

A long-term point-to-point evaluates the growth the same way, except the measurements are separated by a longer horizon. For example, a three-year point-to-point means the first measurement is taken on the issue date and the second at the end of the third year. No interest is credited until the annuity reaches this second point, three years later.

For example, the index value was at 100 on the first day of the period. If the index value was at 150 at the end of the period the gross index gain would be 50% (150-100/100). The company would credit a percentage of this gain, by applying a participation rate. If the participation rate was 80% the index annuity would be credited with a total return of 40% interest (50% index gain x 80% rate) for the period.

Regardless of which version of point-to-point is used, the difference between the two values (or points) represents the gain in the index before participation rate, cap rate and/or spread yields are applied.

**The High Watermark Method**

A high watermark annuity measures the difference between the index value from the time the contract is purchased to the point when the index reaches its highest level in the given term. In a five-year contract, for example, the highest of the index’s value on all five anniversary dates would be the high mark.

Like point-to-point and monthly averaging, some percentage of the growth will be applied to the contract using a participation rate, cap rate, and/or spread yield.

The high-water mark method performs best when the market rises to a high level and then surrenders a significant portion of the gain over the remainder of the contract term. The high-water mark represents less than one percent of sales and is not a major method used today.

**LOW-WATER MARK**

This is a variation of the high-water mark annuity. A low watermark product measures the difference in the index value between the anniversary date on which the contract reaches its lowest mark and the end of the contract’s term. This difference is the basis for the amount of interest credited to the annuity.

**THE ANNUAL RESET PROVISION**

An important feature found in many equity-indexed annuities is the annual reset provision. With an annual reset design, the index to which the annuity is tied is marked at the beginning and end of each contract year. The difference in the index value each year is the basis for the amount of interest credited to the product. Any declines are ignored. The annual reset provision has many benefits for seniors.

First, the annual reset provision locks in gains each anniversary and protects all previous years’ interest from being lost in subsequent years.

The annual reset provision also provides new growth potential each year by resetting the index starting point. This presents a new opportunity for gain after the index suffers a severe downturn the previous year by using the lower value as its reset point for the year ahead.
Most seniors prefer fixed annuities to variable annuities partly because they can access income through interest withdrawals. With equity-indexed annuities, the annual reset provision is an important feature to evaluate when determining suitability for seniors. Without it, index gains cannot be credited annually and are not available to withdraw.

The annual reset method works well under volatile market conditions and has become popular in the past two years. This method also provided the best index participation potential when taking out periodic or systematic withdrawals.

**EQUITY-INDEXED ANNUITIES MAY OFFER A COMBINATION OF METHODS**

Each of the interest rate crediting strategies reacts differently to the market's performance. Some products offer a combination of interest rate crediting strategies. Many of today's products include both monthly averaging and point-to-point methods. This offers the consumer the flexibility to decide how funds will be allocated at issue and funds can be reallocated each anniversary between methods and index options.

**SPREAD/MARGIN/ASSET FEE**

Some EIAs use a spread, margin or asset fee in addition to, or instead of, a participation rate. It is stated as a percentage deduction from the amount of indexed interest and it is used to cover the expense of purchasing index options and other underlying expenses. This percentage will be subtracted from any gain in the index linked to the annuity. For example, if the index gained 10% and the spread/margin/asset fee is 3.5%, then the gain in the annuity would be only 6.5%.

**CAP RATE OR CAP**

Some equity-indexed annuities place a cap on the rate of interest that may be credited. Even if reference to the index would produce a higher rate, the rate credited to the annuity will not exceed the cap. Not all equity-indexed annuities have caps. They are often used in conjunction with a participation rate and are common in EIAs with an annual reset design. Annuities that have a cap may also have a higher participation rate.

**Participation Rates**

A participation rate determines how much of the gain in the index will be credited to the annuity. The percentage stated (participation rate) is multiplied by the amount of increase in the index value to determine the indexed interest. For example, the insurance company may set the participation rate at 80%, which means the annuity would only be credited with 80% of the gain experienced by the index.

When the S&P 500 value increases 10 percent, an EIA with an 80 percent participation rate will receive indexed interest credit of 8 percent.

The participation rate may vary greatly from one annuity to another and from time to time within a particular annuity. It is important for agents to be able to explain to clients how their annuity's participation rate works with the indexing method. A high participation rate may be offset by other features, such as averaging, or a point-to-point indexing method. On the other hand, an insurance company may offset a lower participation rate by also offering a feature such as an annual reset indexing method.

**MINIMUM GUARANTEED INTEREST RATE**

Minimum guaranteed interest rates afford seniors a greater peace of mind when purchasing an annuity. The equity-indexed annuity, like other fixed annuities, also promises to pay a minimum interest rate. The rate that will be applied will not be less than this minimum guaranteed rate even if the index-linked interest rate is lower. The value of the annuity will never drop below a guaranteed minimum. The guaranteed value is the minimum amount available during a term for withdrawals, as well as for some annuitization and death benefits. The insurance company will adjust the value of the annuity at the end of each term to reflect any index increases.

With equity-indexed annuities, bonds support the minimum guaranteed rate, but options in an index are purchased to enhance the credited rate.

The minimum guaranteed interest rate accumulates separate from index account. At the end of the contract term, the client receives the greater of:

- (a) the minimum guaranteed value
- (b) the index value.
Not both!

The client receives the greater of these two values when the annuity reaches its term or is surrendered prematurely.

A variety of methods are used to calculate the minimum guaranteed interest rate. Usually, it is calculated as a percentage of the premium deposited.

Different methods of calculating the minimum guaranteed values produce a variety of results. Agents must understand and be able to explain to clients how these variations impact minimum guaranteed values.

THE NAIC MODEL FOR MINIMUM GUARANTEED INTEREST RATES

Some companies are now using the NAIC's Interest-Indexed Annuity Contract Model Regulation as the method for setting the minimum guaranteed interest rates. Under the traditional approach, the guaranteed minimum rate remains constant during the annuity's term. With the NAIC's Model, the minimum guaranteed interest rates can fluctuate within a range each anniversary, based on the interest rates of an external reference.

For the insurance company, this approach allows the company to maintain adequate cash flows during times when prevailing interest rates may be low; but for the agent it adds much more complexity to the guaranteed minimum interest rate. Agents who represent contracts using this method should be sure they understand, and can explain to their clients, how this will affect the growth of their annuity.

PREMATURE SURRENDER CHARGES

Insurance companies who offer deferred annuities impose a penalty for withdrawing funds prematurely, called a surrender charge. Carriers are usually required to disclose that surrender charges exist on the cover of the policy, in addition to sending statements to the contract owner that illustrate the surrender values.

Surrender charges are assessed to help a company recover costs including commissions in the event a policyholder withdraws the funds prior to the term. There is a direct correlation between commissions and surrender charges: The higher the commission – the higher the surrender charges.

Like fixed annuities, the surrender charges in equity-indexed annuities are stated as a percentage and usually vanish over time. When an equity-indexed annuity is surrendered prior to its term, the surrender charge is assessed against the index value and then compared to the minimum guaranteed contractual value. Whichever value is greater becomes the surrender value of the contract.

Agents should carefully evaluate the death benefit provision when recommending equity-indexed annuities to a senior. Some products assess a surrender charge at death unless the beneficiary agrees to take the proceeds over a 5-year period.

This difference can be dramatic especially for beneficiaries who may need the funds in the annuity right away to pay for obligations of the deceased.

Agents should make sure they understand the liquidity provisions of the equity-indexed annuities they sell. Some equity-indexed annuities offer no access to cash values during the policy term, which may last for several years. Others may offer only limited access, while some offer withdrawals on a basis similar to other fixed annuities.

Equity Indexed Annuity Charges & Fees

EIAs are long-term investments. Getting out early may mean taking a loss. Many EIAs have surrender charges. The surrender charge can be a percentage of the amount withdrawn or a reduction in the interest rate credited to the EIA.

Agents should determine what surrender charges may apply and how long the surrender charge period lasts in relation to the indexing period. Often, surrender charges apply for the length of the policy term, at which point there is a “window” during which the owner can withdraw the annuity funds or renew the annuity for another term at the participation percentage declared by the company for that term.

In addition to the surrender and withdrawal charges and free withdrawals, there are additional considerations for equity-indexed annuities. Some annuities credit none of the index-linked interest or only part of it if clients take out money before the
end of the term. The percentage that is vested, or credited, generally increases as the term comes closer to its end and is always 100% at the end of the term.

Also, any withdrawals from tax-deferred annuities before clients reach the age of 59½ are generally subject to a 10% tax penalty in addition to any gain being taxed as ordinary income.
ANNUITY RIDERS

Insurers have developed a variety of riders adding additional features to make annuities more appealing to consumers. The riders discussed in this course are Life Insurance Riders, Long-Term Care Riders, and Guaranteed Monthly Income Benefit Riders. Many other riders may be available in addition to those discussed in this course. Agents should check with their insurers.

LIFE INSURANCE RIDERS

To help reduce the size of the income tax bill that annuity beneficiaries might face, a number of insurers have created specific riders that, for an additional fee, can be added to the core annuity contract.

During the accumulation phase of an annuity, gains are tax-deferred. But at death, under non-qualified annuities, annuity gains are treated as income to the beneficiary and subject to income tax.

Life insurance riders were designed by insurance companies to help beneficiaries offset the income tax due on annuity gains. They are especially suitable for seniors who purchase annuities with no intent to access the funds, but want the proceeds passed on to children and grandchildren upon their death.

If an enhanced death benefit rider is added, the death benefit can increase based on increases in the account value. Typically, this is measured by recording the highest value on any contract anniversary.

ESTATE PROTECTION RIDER

The estate protection rider increases the contract's death benefit by a certain percentage in the event the owner dies before annuitization. The increase, which is designed to help offset the income tax payable on the contract’s gain, is typically a multiple of the contract’s earnings based on the owner’s age at death.

An additional cost for an estate protection rider applies. With a fixed annuity, this cost is absorbed by reducing the amount of current interest credited to the contract. With a variable annuity, the M&E charge is increased.

TERM INSURANCE RIDER

As the annuity value grows, so does the amount of the tax bill due when the owner of the deferred annuity dies. Attaching a term life insurance rider to a deferred annuity helps the annuity owner pass more of the accumulated wealth to beneficiaries.

Under this option, an increasing term rider is attached to the annuity contract. As the annuity credits its interest rates, some portion of the account value increases are withdrawn to apply as premiums on the ever increasing amount of term insurance. At the annuity owner’s death, the beneficiary receives, tax free (or tax reduced) the death benefit from the annuity plus that from the term rider. Because the annuity’s benefit is equal (or close to) to the amount of the original principal, there is no taxable gain. The term rider pays income tax free death benefits.

Income taxes are payable on amounts withdrawn from the annuity to pay the insurance premiums. However, these amounts are minor compared to what beneficiaries would pay were they to receive the traditional gain from the annuity.

Taxation of Life Insurance Rider Benefits

Whether or not the death benefit is taxable depends on how the insurance company reports the cost of the rider. Usually, the cost of the rider is deducted from the earnings of the annuity. If the earnings deducted to cover the cost of the rider are reported annually as taxable income to the owner, the stepped up death benefit is tax-free. If the earnings to cover the cost of the rider are not reported as taxable income to the owner, the stepped up death benefit is taxed.

A Private Letter Ruling (PLR 200022003-72.07-02) from the Internal Revenue Service defines the rules for an annuity and term life combination policy. Death benefit proceeds under the rider are taxed as life insurance and not taxed as annuity proceeds. Rider charges, to the extent extracted from the account value, are taxable distributions under the annuity policy.
LONG-TERM CARE INSURANCE RIDERS IN ANNUITIES

The Long-Term Care (LTC) rider is a popular option. According to the U.S. Census Bureau, the number of persons over age 65 is expected to double by 2030. More people together with increased costs equals a viable need for LTC coverage which LTC riders help to fill.

Long-term care is a social and family issue that is becoming an increasing concern to Americans. With increased life expectancies, an aging Baby Boomer population, and a variety of socioeconomic trends, paying and providing for long-term care has become a serious problem.

Seniors are increasingly aware of the need for long-term care insurance. Still, paying expensive premiums for LTC insurance remains a barrier, especially when premiums become so much more expensive in the advanced years when a person may finally appreciate the need for the coverage and begin shopping for coverage.

In light of this, many consumers are purchasing long-term care insurance to plan ahead for the possibility of someday needing long-term care. Annuity providers accustomed to an aging marketplace have developed annuities with long-term care insurance riders to help meet this need for LTC coverage.

Many LTC riders are similarly constructed, providing coverage for catastrophic illnesses which require home health care, like an in-home nurse or aide, or long-term hospitalization, or a nursing home stay. These riders are designed to provide benefits without cutting into the monthly payments you receive from an annuitized annuity.

TWO TYPES OF LTC RIDERS

There are generally two types of long-term care riders - underwritten and non-underwritten. Underwritten riders typically offer richer benefits closer to those found in stand-alone LTC policies than non-underwritten riders.

Medically Underwritten Long-Term Care Riders

When a claim occurs, the insured's annuity value is used to fund qualified LTC expenses. Most underwritten riders require the annuity's value to be completely used up before access to the rider's benefit can begin. Once the annuity value has been depleted, the rider continues paying for LTC expenses, subject to the maximum benefit of the rider.

Underwritten riders, similar to conventional long-term care insurance, require detailed applications and face-to-face assessments to establish acceptability. Underwritten riders also utilize industry standard policy provisions and definitions such as benefit triggers, elimination periods, benefit maximums and inflation protection.

The long-term care provisions of the policy are generally triggered by a physician's certification that the insured is chronically ill and unable to perform a specified number of daily living activities. The long-term care provided may involve a deductible period, but it can be defined to cover care in an assisted living facility or home health care as well as confinement in a nursing home. LTC riders also cover both Alzheimer's Disease and similar forms of irreversible mental impairment.

Non-medically Underwritten Long-Term Care Riders

Non-medically underwritten long-term care riders are more limited in the scope of benefits they contain, but they appeal to consumers who cannot purchase medically underwritten long-term care insurance due to medical conditions.

With annuities that offer non-medically underwritten riders, a cost for the rider is deducted from the annuity's cash value to create a separate fund for long-term care expenses. Funds withdrawn from the long-term care fund do not deplete the annuity account.

Provided the insured meets the benefit triggers and satisfies the elimination period (if any), a percentage of the long-term care account may be accessed. Benefits are usually further limited by a maximum benefit period.

SUITABILITY OF LTC RIDERS

LTC riders on annuity contracts are usually more limited than conventional LTC policies on the market today and may also be subject to different, often stricter, coverage triggers. When working with seniors, a number of factors should be considered when evaluating annuities with LTC riders.

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Non-medically underwritten riders cannot be accessed until the contract has been in force long enough to protect the carrier from the effects of adverse selection, commonly five to seven years.

- With a non-medically underwritten rider your client’s life expectancy should be longer than the waiting period on the rider or the rider may not be suitable since the likelihood of accessing benefits diminishes.
- If your client is considering an annuity with a LTC rider in place of conventional long-term care insurance, take the time to explain the differences between the two. LTC riders should not be sold as substitutes for LTC policies.
- These riders do not participate in California’s Partnership for Long-Term Care Program. Clients who purchase an annuity with a long-term care rider will not be eligible for expanded asset protection from Medi-Cal, as well as other consumer safeguards in a Partnership Policy. For more information: www.dhs.ca.gov/cpltc

**TAXATION OF LTC RIDER BENEFITS**

The Health Insurance Portability and Accountability Act of 1996 addressed the tax treatment of long-term care insurance benefits and premiums. Specifically, if long-term care insurance contracts designed to be “tax-qualified” in accordance with the provisions of HIPAA, benefits received from LTC policies and riders are not considered as taxable income.

While the benefits of an LTC rider may be considered income tax free if the rider complies with HIPAA, the annuity value (which may be required to be spent down first) receives the tax treatment in accordance with Section 72 of the Internal Revenue Code. Interest is withdrawn first and considered taxable income. This method is referred to as LIFO, or Last In, First Out. Also for withdrawals made from the annuity prior to the owner reaching age 59½, all interest withdrawn will be subject to a 10% excise penalty tax. After earnings have been withdrawn, the premiums withdrawn are not subject to income tax.

For LTC riders that do not comply with HIPAA’s standards, benefits may be subject to income tax. In some situations, the deposit is treated as gain and is taxable as ordinary income when withdrawn. Also, if the owner is younger than 59½ at the time such withdrawals are made, the 10% excise tax applies.

**Using Annuities to Pay LTC Premiums**

Once an individual’s need for long-term care insurance has been established, the major roadblock to obtaining adequate coverage is often affordability. Annual premiums for long-term care insurance policies often range from $1,500 to $5,000 or more. An individual cannot be sure that, along with all of his or her other needs for income, the money will be available to pay the long-term care insurance policy premium every year for as long as he or she lives especially after the individual has retired and no longer has income from employment?

One alternative is to purchase a single-premium immediate annuity that would generate the necessary premium amount each year for as long as the individual lived. The older the individual is, the less such an annuity would cost. For example a prospect age 60 might be able to purchase an annuity guarantying $5,000 of income for life for about $85,000. At age 65, however, the same single-premium annuity would only cost about $67,000.

The annuity would be guaranteed to generate the necessary premium amount, and, because of the exclusion ratio, the annuity payment is largely tax-free during the period of the individual’s life expectancy. If the individual lived past his or her life expectancy and the entire premium was returned to him or her, annuity payments would become fully taxable from that point on.

Another alternative for funding long-term care insurance policy premiums with annuities involves split-funding in connection with long-term care insurance policies that become paid-up after a certain number of years. Agents could sell a long-term care insurance policy that became paid-up after 10 equal annual premium payments along with a 10-year single-premium immediate temporary annuity in an amount sufficient to pay those 10 premiums. At the same time, they could sell a deferred annuity whose accumulations in 10 years would match the amount paid for the single-premium immediate annuity. At the end of the 10 year time period the client would have a paid-up LTC policy and full amount of their original investment as well.
Riders Compared To Crisis Waivers

Long-term care insurance riders are different than crisis waivers. An annuity containing a long-term care insurance rider provides separate insurance benefits which cover expenses across the long-term care continuum including nursing home care, assisted living facility care, home and community-based care.

A nursing home crisis waiver merely eliminates surrender charges upon withdrawal of funds from the annuity in the event a nursing home admission occurs after the annuity was purchased. No insurance benefit is provided, and the crisis waiver does not apply to all aspects of the long-term care continuum such as home care, assisted living or adult day care.

In California, agents who sell long-term care insurance, including life insurance and annuity contracts containing long-term care insurance riders, are required to complete additional training as a pre-requisite. Agents selling policies with LTC waivers would not be required to take this special training.

LOAN PROVISIONS

Loan provisions are another means to access annuity funds. Loan provisions on annuities began with Tax-sheltered annuities (TSAs), also called 403(b) annuities. TSAs were created by Congress to supplement retirement benefits for the educational community. Loans on these annuities receive preferred tax treatment as well if they are structured and paid back according to IRS guidelines.

Though loan provisions are usually found in most qualified annuities, some of the newer nonqualified annuities have also incorporated loan provisions. These loans are typically available to contract owners at a low cost. However, annuity loans are considered distributions from annuity contracts and therefore are taxable. If a loan is taken before the annuitant reaches age 59½, a 10 percent early withdrawal penalty also applies.
ANNUITY TAXATION

It's essential for agents to understand the impact of annuity taxation on their clients and their beneficiaries because the agents must be in a position to recommend the proper retirement- or estate-planning option. Much of the planning focuses on the impact of taxes on the structure of the annuity contract.

Annuities may be a significant part of an individual's comprehensive financial plan. There are special income tax rules that apply to annuity contracts. This course provides a general discussion about taxes and annuities. Clients should consult a professional tax advisor to discuss their individual tax situation. Agents should not attempt to provide legal or tax advice unless they possess the credentials to do so.

THE TAX STATUS OF ANNUITIES

Under current federal law, annuities receive special tax treatment. Income tax on annuities is deferred, which means they aren't taxed on the interest their money earns while it stays in the annuity. Tax-deferred accumulation isn't the same as tax-free accumulation. An advantage of tax deferral is that client's tax bracket may be lower when they receive annuity income payments than during the accumulation period. They will also be earning interest on the amount that would have been paid in taxes during the accumulation period. Most states’ tax laws on annuities follow the federal law.

The taxation of the actual annuity payments under the contract is subject to specific tax rules. In addition, such payments are typically deferred for some period of time after the inception of the contract, either until the annuitant reaches a specified age or for some period thereafter at the discretion of the contract owner. During this period of "deferral,” the funds in the contract are generally permitted to accumulate on a tax-deferred basis. However, if a withdrawal, loan, or other financial transaction involving the contract is done before the commencement of the stream of annuitized payments, additional tax rules apply to the transaction.

QUALIFIED VS. NONQUALIFIED ANNUITIES - TAXATION

Qualified annuities used to fund certain employee pension benefit plans (those under Internal Revenue Code Sections 401(a), 401(k), 403(b), 457 or 414) defer taxes on plan contributions as well as on interest or investment income. Within the limits set by the law, pretax dollars can be used to make payments to the annuity. When money is taken out, it will all be taxed.

Annuities can also be used to fund traditional and Roth IRAs under Internal Revenue Code Section 408. If an annuity is used to fund an IRA, purchasers must receive a disclosure statement describing the tax treatment.

The term Qualified (when applied to Annuities) refers to the tax status of the source of funds used for purchasing the annuity. These are premium dollars which until now have "qualified" for IRS exemption from income taxes. The whole payment received each month from a qualified annuity is taxable as income (since income taxes have not yet been paid on these funds). Qualified annuities may either come from corporate-sponsored retirement plans (such as Defined Benefit or Defined Contribution Plans), Lump Sum distributions from such retirement plans, or from such individual retirement arrangements as IRAs, SEPs, and Section 403(b) tax-sheltered annuities, or Section 1035 annuity or life insurance exchanges.

The qualified plan market is complex. Because qualified plans are funded with contributions that use pre-tax dollars, a qualified plan must satisfy specific provisions set forth by the Internal Revenue Code. Each type of qualified plan has its own unique definitions, limitations and exceptions.

The term "tax-qualified plan" can refer to a number of different types of retirement plans that qualify for special treatment under federal income tax law. The major tax breaks qualified plans provide are as follows:

1. Amounts contributed to the plan are not income taxable to the individual until they are paid out of the plan.
2. Earnings in the plan are not income taxable to the individual until they are paid out of the plan.
3. If it is an employer-sponsored plan, contributions made by the employer are tax-deductible to the business.

Non-qualified annuities are purchased with monies which taxes have already been paid. A part of each
monthly payment is considered a return of previously taxed principal and therefore excluded from taxation. The amount excluded from taxes is calculated by an Exclusion Ratio, which appears on most annuity quotation sheets. Non-qualified annuities may be purchased by employers for situations such as deferred compensation or supplemental income programs, or by individuals investing their after-tax savings accounts or money market accounts, CD’s, proceeds from the sale of a house, business, mutual funds, other investments, or from an inheritance or proceeds from a life insurance settlement.

For non-qualified annuities, part of the payments received from an annuity will be considered as a return of the premium paid. Clients won't have to pay taxes on that part. Another part of the payments is considered interest earned. They must pay taxes on the part that is considered interest when withdrawn may also have to pay a 10% tax penalty if they withdraw the accumulation before age 59½. The Internal Revenue Code also has rules about distributions after the death of a contract holder.

Annuity taxation involves the concept that the contract owner's capital investment in the contract may be recovered tax free when distributions are made. But the interest or other earnings on the contract funds must be subject to taxation at some point in time.

**CONTRASTS BETWEEN QUALIFIED & NON-QUALIFIED**

For tax purposes, an annuity may be qualified or non-qualified. Non-qualified annuities are funded using after-tax dollars. Qualified annuities are funded with pre-tax dollars, as part of plans like Individual Retirement Accounts (IRAs), Simplified Employee Pension Plans (SEPs), Tax-Sheltered Annuities (TSAs) or other employer-sponsored retirement plans recognized by the Internal Revenue Service.

Anyone may purchase a nonqualified annuity for any reason. A qualified annuity is purchased as part of a tax-qualified individual or employer-sponsored retirement plan, such as an IRA, a TSA or any other plan recognized by the Internal Revenue Service. Many of these qualified plans allow employees to fund their annuities through salary reductions. These contributions are made with pretax dollars, thus lowering the employees' current taxable income. The contributions then grow within the plan on a tax-deferred basis.

Differences between annuities purchased to fund qualified plans and those purchased on a nonqualified basis arise from the requirements qualified plans must meet in order to qualify for and maintain their favorable tax treatment.

For example, in a qualified plan there are limitations on the amount that can be contributed to the plan and deducted from an individual's income in one year. The amount of premium that can be paid to purchase an annuity on a nonqualified basis is limited only by maximums set by some insurers.

Qualified plans and 403b arrangements are required to begin making certain minimum distributions by April 1 of the year following the year in which the individual turns age 70 ½. Minimum distributions may be taken in the form of withdrawals based on life expectancy or annuity payments. For annuities purchased on a non-qualified basis, distributions from the contract need not begin until the owner desires, if at all.

**ANNUITY TAX LEGISLATION**

To market and sell annuities effectively, the agent must understand the tax aspects of these products and how they affect contract owners and their beneficiaries. Over the years, changes in the tax laws have served to encourage the use of annuities as retirement-planning vehicles and discourage their use as short-term tax-sheltered investments. Following is a brief look at the history of annuity tax legislation.

**TEFRA (1982)**

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) was really the first significant piece of legislation to have an impact on annuities.

- Changed taxation of non-qualified annuities from FIFO to LIFO. Prior to 1982, amounts received under an annuity before an annuity starting date, such as withdrawals, were first treated as a return of the policyholder's premiums. Since the 1982 changes, withdrawals are now taxed on an income-out-first basis.
- Loans are treated as distributions (subject to the income-out-first rule).
• Assignments or pledges of annuity contracts are treated as distributions (subject to the income-out-first rule).
• A 5% penalty tax was imposed on certain distributions from annuity contracts prior to age 59 ½ if withdrawals were within 10 years of the purchase date.

DEFRA (1984)

Under Deficit Reduction Act of 1984:

• The excise penalty was broadened to apply to any withdrawals prior to age 59½. (with certain limited exceptions)
• A new distribution at death rule was imposed. As a result, to be treated as an annuity, the contract must contain specific language requiring distributions upon death of the contract owner or annuitant. This prevented continuing deferral of tax after the death of the owner/annuitant except for a husband and wife.
• Contracts issued prior to January 1, 1985 were grandfathered exempt from these changes.

Tax Reform Act (1986)

The Tax Reform Act of 1986 (TRA) changed the tax treatment for annuities.

• The inside buildup was taxed if the owner of the annuity was not an individual (i.e. this corporations).
• The excise penalty tax on distributions prior to age 59 ½ was increased from 5% to 10%.
• Transfers and gifts of annuity contracts are treated as taxable distributions to the transferor, unless the transfer is between spouses.

TAMRA (1988)

The Technical and Miscellaneous Reform Act of 1988 (TAMRA) dealt with the aggregation rule.

• All deferred annuity contracts issued by the same company to the same policyholder during any calendar year were treated as one annuity contract. This rule prevents avoidance of the income-out-first rule through the use of multiple deferred annuities.

OBRA (1990)

Under the Omnibus Budget Reconciliation Act of 1990

• The aggregation rule (multiple deferred annuity contracts) does not apply to immediate annuities.

Small Business Act (1996)

The Small Business Job Protection Act of 1996 contained a number of provisions related to qualified plans and pension simplification. It affected the taxation of qualified annuities by modifying the exclusion ratio formula used to determine plan participant basis and the nontaxable portion of qualified annuity payments.

PREMIUMS

From an income tax standpoint, the main difference between purchasing an annuity inside or outside of a qualified plan concerns the deductibility of the premium.

Contributions to a qualified plan, including premiums paid for an annuity funding a qualified plan, are generally deductible from current income. Premiums paid on annuities purchased on a nonqualified basis are not tax-deductible. Qualified plan annuities can be purchased with before-tax dollars, while nonqualified plan annuities are purchased with after-tax dollars.

With some exceptions, contributions to most qualified plans - including qualified annuities - are deductible from current income up to the limits specified by the IRS. The amount that can be deducted depends on the type of qualified plan used.

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<th>Tax-Deductible Limits Of Qualified Plans, 2006</th>
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If contributions to qualified plans exceed the allowable limits, the IRS will assess a penalty each year until corrected. For this reason, agents selling qualified annuities must carefully ascertain that
contributions are within the guidelines of the particular plan.

**Traditional IRAs**

Where traditional IRAs are concerned, the contribution may not be tax deductible if the individual is already participating in another qualified plan. The determining factor will be income.

**Exceeding IRA Contributions Can Trigger Penalties**

Excluding rollover contributions, individuals who exceed the contribution limits for traditional or Roth IRAs are liable for a non-deductible penalty tax of 6% of the over-funded amount each year until the overpayment is corrected.

Contributions to a non-qualified annuity are not deductible for income tax purposes; however, annuities still receive special tax treatment by the IRS, as described in detail in Section 72 of the Internal Revenue Code. Unlike other investments, such as certificates of deposits and mutual funds, the earnings in an annuity are not subject to ordinary income taxes until they are withdrawn.

**Tax Treatment of Cash Values**

Annuities can be used to fund qualified plans, but even annuities purchased outside of a qualified plan provide income tax deferral on earnings until they are withdrawn.

Qualified annuities are similar to non-qualified annuities where income tax on the earnings is concerned. For example, qualified annuities also defer taxation on contributions and earnings until they are distributed. The IRS treats some aspects of qualified annuities differently.

Tax free build-up within the contract is allowed only to “natural persons.” If an annuity contract is held by a corporation or trust, then the income on the contract is treated as ordinary income received or accrued by the owner during that taxable year.

A trust acting as the agent for a natural person would be considered a natural person. But if an employer is the agent for its employees, the employer will be taxed on the inside build up. This means annuities are no longer appropriate tax advantaged investments for nonqualified deferred compensation agreements. Exceptions from the “natural persons” rules allow tax-free build up of the following annuities:

- Annuities received by the executor of a decedent at the decedent’s death,
- Annuities held by a qualified retirement plan or IRA,
- Annuities considered “qualifying funding assets” (used to provide funding for structured settlements and by property and casualty insurance companies to fund periodic payments for damages),
- Annuities purchased by an employer on termination of a qualified plan and held until all amounts under the plan are distributed to the employee or his beneficiary,
- Annuities which are “immediate,” i.e., those which have a starting date no more than one year from the date the annuity was purchased and provide for a series of substantially equal periodic payments to be made at least annually over the annuity period.

Since annuities were given their unique tax treatment to encourage long-term savings for retirement, changes to the tax code through the years discourage their use as short-term tax-sheltered investments.

**INCOME TAXATION ON WITHDRAWALS**

The funds in a deferred annuity contract accumulate free of income taxation until one of the following occurs:

- a loan, collateralization, or withdrawal from the contract;
- an annuitization of the contract; or
- the death of the contract owner.

Partial withdrawals or loans from an annuity contract during the deferral or accumulation period are subject to different income tax rules than actual annuitized payments. Withdrawals and loans are treated as taxable events for income tax purposes. No exclusion ratio applies.

If any portion of a deferred annuity’s value is attributable to earnings, a withdrawal will be considered to come from those earnings before it is considered to come from premiums paid into the contract. Deferred annuity earnings are...
income-taxable when paid out of the contract, while amounts representing premiums for non-qualified plans are not income-taxable when paid out of the contract.

A withdrawal is any amount distributed from the annuity that is not part of the annuitization process. Those payments are taxed based on when the annuity was purchased. If a taxpayer owns a contract that was funded on or before August 13, 1982, "FIFO" ("first-in, first-out") rather than LIFO taxation will apply to a withdrawal from the contract. This means that the taxpayer will be able to treat the distribution as a nontaxable return of capital until the taxpayer's investment in the contract has been fully recovered.

Investments made after August 13, 1982, are taxed on a last-in, first-out basis. That means for income tax purposes the first money out of the annuity will be considered as earnings, not principal, and will be taxed as ordinary income when withdrawn from the contract.

The interest-out-first rule for withdrawals, is in contrast to taxation of annuitization payments, where a portion of those payments is excludable from income taxation. The purpose of the favorable tax treatment of annuity payments is to encourage the use of annuities as long-term savings vehicles. In contrast, the purpose of the interest-out-first rule for withdrawals is to discourage the use of annuities for short-term savings.

All withdrawals from qualified annuities are subject to income tax, unless the withdrawal represents some return of cost basis. Roth IRAs are treated differently than most qualified plans in this area. Under Roth IRAs, ordering rules apply to distributions.

- Contributions are withdrawn first and are not subject to income tax or the 10% penalty tax.
- Conversions from traditional IRAs are withdrawn second and are not subject to income tax or the 10% penalty tax provided they have remained in the account for at least 5 years.
- Earnings are withdrawn last and are treated as follows:
  - If the distribution meets the following rules, the earnings are tax-free:
    - The Roth IRA has been in force for at least 5 years; AND
  - The owner is older than 59½; OR
  - The owner makes a first-time home purchase; OR
  - The owner dies or becomes disabled.
  - If the distribution does not meet those rules, earnings are subject to income tax. Also, if the owner is younger than 59½, the 10% penalty tax applies.

Contract owners have a number of ways to access the values in their annuities other than through annuitization. These options include systematic withdrawals, loans and full or partial surrenders, all of which can be used before an annuity's maturity date. However, current tax laws are such that any of these distribution options may create a taxable event.

**Annuities Purchased Before August 14, 1982**

For an annuity purchased before August 14, 1982, the general rule regarding cash withdrawals, amounts received as loans or amounts received on surrenders is that they are tax free until they equal the contract owner's basis or investment in the contract. After that, they are fully taxable as income. Such annuities are given first-in, first-out treatment.

**Annuities Purchased After August 14, 1982**

For an annuity purchased on or after August 14, 1982, the general rule regarding these same kinds of distributions is that they are treated first as fully taxable interest payments and only second as a recovery of nontaxable basis. Such annuities are given last-in, first-out treatment.

**SYSTEMATIC WITHDRAWALS**

Individuals may withdraw money from their deferred annuities on a regular basis in order to provide income over an extended period of time. Withdrawals that take place on a regular, ongoing basis are often referred to as "systematic withdrawals."

Many of today's deferred annuities are designed to give individuals the option of using systematic withdrawal plans as an alternative to the
annuitization. Contracts allow the "annuity starting date" or "the maturity date," to be deferred to a late age.

There are several important differences between obtaining income from a deferred annuity by way of annuitization or through systematic withdrawals. These are the advantages and the disadvantages of systematic withdrawal plans compared to converting premiums to an income stream through annuitization.

**DISADVANTAGES**

- Systematic withdrawals do not guarantee an individual an income for life.
- Systematic withdrawals do not receive the same favorable tax treatment as annuity payments. Like any other withdrawal, systematic withdrawals are subject to the interest-out-first rule, meaning that the entire amount of any withdrawal is taxable as income until all amounts representing interest earnings have been taken out of the annuity. In addition, if the individual is under age 59½, the taxable amount of any withdrawal may be subject to the 10% penalty tax.

**ADVANTAGES**

In spite of the disadvantages, many individuals prefer systematic withdrawals to premium conversion because of the following advantages.

- **Control of funds.** Before annuity funds are converted to an income stream, the individual maintains a high degree of control over that money.
- **Potential for higher returns.** The ability to earn a current rate that will remain competitive with prevailing rates being offered on other financial vehicles, rather than being locked into a guaranteed return, is a feature that makes systematic withdrawals attractive to many people.
- **Value to Heirs.** The value that remains in an individual's deferred annuity at his or her death is payable to a beneficiary. If the individual died shortly after beginning to take systematic withdrawals, a large portion of the annuity's value would remain in the contract.

**FREE WITHDRAWALS**

The annuity free withdrawal, introduced in the late 1970s, allows a contract owner to withdraw a stipulated amount from his or her annuity without incurring any surrender charges. A typical free withdrawal provision would allow up to 10% of the annuity value to be withdrawn each year before a withdrawal charge would be applied. But there are many variations of free withdrawal provisions. Some allow only interest to be withdrawn without a charge. Others allow a percentage of premium to be withdrawn only after it has been in the contract for a certain period of time.

**The 10 Percent Penalty for Premature Distributions**

To promote the use of annuities as retirement plans and to discourage their use as short-term tax-sheltered investments, in almost all cases, funds taken out of an annuity before age 59½ will be subject not only to ordinary income tax but an ADDITIONAL 10% PENALTY tax as well. It may not be worthwhile to consider an annuity should clients need the money prior to 59½. Therefore, an individual who, at age 54, withdraws $5,000 from his or her annuity must pay a current tax plus a $500 penalty, to the extent the withdrawal is attributed to interest earnings. No penalty is imposed for distributions taken:

Subject to provisions of Section 72(q) of the Internal Revenue Code, there are exceptions where the tax does not apply. **Exceptions to the 10% excise penalty tax:**

- after age 59½;
- in the event of disability;
- in the event of death; or
- as part of a series of substantially equal payments taken over life expectancy.

A 10 percent penalty tax generally applies to amounts received from annuity contracts that

- are not received in the form of annuity payments and
- are received by a taxpayer who has not attained the age of 59½.

This 10 percent penalty tax applies only to the portion of any withdrawal, loan, or collateralization of the contract that is taxable under the rules above. It applies in addition to the regular income tax. It
does not apply to the portion of the transaction that is a nontaxable return of capital.

Deferred annuity earnings attributable to premiums paid into the contract on or before August 13, 1982 are not subject to the 10% penalty tax on premature withdrawals.

**INCOME TAXATION ON CONTRACT SURRENDER**

Complete surrenders of annuity contracts are taxable to the extent that the cash value of the annuity exceeds the investment in the contract. However, in the case of a complete surrender of the contract, the taxpayer is permitted to reduce the cash value by any surrender charges in order to determine the taxable amount.

**INCOME TAXATION ON LOANS**

The so called “interest first” (amounts received are treated first as interest income and further amounts are considered a recovery of cost) rule was imposed to discourage the use of annuity contracts as short term investment vehicles. Under this rule, a loan is considered a cash withdrawal.

With the exception of tax-sheltered annuities, taking a loan from an annuity or even using the annuity as collateral is considered a distribution from the annuity and taxable as income. (Ref. Section 72 (e)(4)(A) of IRC)

Annuities designed for purchase on a nonqualified basis generally do not contain loan provisions because loans are treated the same as withdrawals for tax purposes. The amount borrowed would be taxable as income and a 10% penalty tax might apply. Since the tax consequences of loans and withdrawals are the same, paying interest on a loan is an unnecessary cost compared to an interest-free withdrawal.

However, as a qualified plan, 403b annuities can offer loans that aren't recognized as income if certain requirements are met:

- In general, loans must be repaid within five years, although loans obtained to purchase a principal residence may have a term longer than five years.
- Loans must be amortized on a substantially level basis, and payments must be made at least quarterly.

- Loans to an individual cannot exceed the lesser of $50,000 or one-half of the present value of the individual's nonforfeitable accrued benefit (however, even if this latter amount is less than $10,000, a minimum loan of $10,000 may still be permitted). If the individual has taken out a loan previously, the $50,000 limit is reduced by the excess of the highest balance owed during the previous one-year period over the outstanding loan balance.

If a loan failed to meet these requirements the amount borrowed becomes a distribution taxable as income and subject to the 10% penalty tax if the individual is under age 59½ and no exceptions apply.

Policy loans on nonqualified annuities are a fairly recent development, created as an alternative to the 10 percent free withdrawals. Policy loans in nonqualified annuities differ significantly from qualified loans in that nonqualified annuity loans are taxable and, if taken before age 59½, can result in a premature distribution penalty of 10% as well.

Interest charged on policy loans is usually tied to independent indexes. In a typical policy loan arrangement, the insurer allows the contract owner to borrow up to 75 percent of the accumulated account value. The contract owner almost always pays a minimum interest charge.

**INCOME TAXATION ON 1035 EXCHANGES**

Section 1035 of the Internal Revenue Code provides that certain tax-deferred instruments can be exchanged for similar contracts without any tax consequences. Specifically, Section 1035 stipulates that "no gain or loss shall be recognized on the exchange of:

- a contract of life insurance for another contract of life insurance or an endowment;
- a contract of life insurance for an annuity contract; or
- an annuity contract for an annuity contract.

An annuity contract CANNOT be exchanged for a life insurance contract.

To avoid taxation of any gain in the existing annuity, the individual must receive no cash in the transaction. The entire value of the existing annuity
must be used to fund the new annuity, and the new annuity must be payable to the same party that the existing one was. To assure that the transaction will be treated as a tax-free exchange rather than a surrender of the contract (which is a taxable event) and purchase of another, the value of the existing contract should be assigned to the company that will issue the new contract at the time the new contract is applied for. Companies have developed forms and procedures that meet these requirements.

Indirect rollovers (when the participant/owner takes receipt of the funds) have other consequences as well. Distributions made from qualified retirement plans, like 403(b) annuities and 457 plans, are subject to automatic withholding tax in the amount of 20%. Internal Revenue Code considers the withholding a distribution unless it is added to the 80% received and re-allocated during the 60-day limit.

Besides meeting the requirements of federal income tax law, agents should also be sure that exchanges comply with any applicable state laws and professional guidelines governing replacements. In most states, such a transaction would meet the definition of replacement and would be subject to strict notification and reporting requirements.

Agents also have an ethical obligation to assure that the exchange is in the best interest of the customer. An agent must evaluate all the financial and non-financial aspects of the transaction. The agent should determine how the customer stands in regard to contract expenses and surrender charges under each contract. Agents should compare each company's interest-crediting or fund management history, financial soundness, and payout options. The agent should analyze other contract features that are being gained or lost in the transaction.

While there are certainly many cases where a customer will be better off replacing one annuity with another, the intent of Section 1035 is to eliminate adverse tax consequences on qualifying exchanges, not to promote inappropriate replacement sales.

Life agents who replace annuities (or life insurance) with annuities have certain basic responsibilities that apply to all consumers. In some states, agents have even stricter requirements for senior clients.

Before an agent recommends a replacement, he or she first should think about how it would benefit the client, then about how the agent would justify the transaction to an examiner.

Much of the growth in sales of annuities in recent years has resulted from Section 1035 Exchanges. Even though some annuity enhancements have made newer annuities more attractive, agents must be sure that the exchange meets their client's objectives. Annuities are long-term, retirement-oriented investment vehicles, and exchanging them may not be best for the client.

Insurance agents recommending the exchange of an annuity contract must tell clients important facts about the pros and cons of the exchange. Insurance agents are permitted to recommend such an exchange only if it is in the client's best interest and only after evaluating their personal and financial situation and needs, tolerance for risk, and the financial ability to pay for the proposed contract. This "suitability" obligation is required by law.

**INCOME TAXATION ON GIFT OF ANNUITY**

Under certain circumstances, it may be beneficial for the owner to gift a non-qualified annuity to another natural person. Under current tax law, a person who gifts a nonqualified annuity to a natural person will pay taxes on the gain in the contract. The recipient takes a new stepped-up basis.

If and when an annuity owner makes a gives his annuity to someone else (i.e. a son or daughter), the donor of the gift (person gifting the annuity) must recognize any gain on the contract at the time of the gift as current ordinary income. Because the donor usually has no cost basis in a qualified annuity contract, the entire cash value would be included in their income in the year of the gift. The rule does not apply to situations involving divorce decree gifts or to gifts made to a spouse.

In addition to the income tax, the contract owner making the gift may also have made a taxable gift if, the accumulated value of the annuity exceeds the annual gift tax exclusion amount. If the gift is a taxable gift, the donor must file a gift tax return and pay any gift tax due.

When contracts that were issued after April 22, 1987 are gifted, the owner has a taxable event at the time of the gift. The amount taxable to the donor (owner) is the cash surrender value of the contract minus the investment in the contract.
When annuity contracts that were issued on or before April 22, 1987 are gifted, the donor (owner) does not have a taxable event at the time of the gift. However, if the donee later surrenders the contract, the donor will be taxed on an amount equal to the difference between the cash surrender value and the investment in the contract as of the time of the prior gift (not as of the time of surrender). The balance of the gain upon surrender of the contract will be taxable to the donee.

**CHARITABLE GIFT ANNUITY**

A charitable gift annuity is an agreement by a charitable institution to pay a lifetime income to a donor in return for a gift of property. The donor gets an immediate income tax deduction for the gift of the property, but as each payment is made, the donor incurs liability for the following:

1. Capital gains taxes on the portion of each payment representing appreciation in the value of the property at the time of the gift.
2. Income taxes on the portion of each payment representing the excess of total payments over the property's appreciated value.

The donor's original investment in the property is spread over the donor's average life expectancy and can be excluded from taxation until the entire amount is recovered. If payments cease upon the donor's death, the charitable gift annuity removes the property from the donor's estate for estate tax purposes.

**INCOME TAXATION ON SALE OF ANNUITY BY OWNER**

How the IRS treats an annuity sold by an owner depends on whether the annuity has matured. If the annuity has not yet matured, the gain in the contract at the time of the sale is treated as ordinary income, subject to income tax. It is not considered as capital gains.

If, however, the annuity is sold after maturity, cost basis is reduced by the aggregate amount of the payments that represent a return of investment.

There are typically two types of annuities, what are known as assignable annuities or self-owned annuities (generally these assignable annuities are purchased by an individual for the benefit of a spouse or child and pay a monthly payment to the recipient for a specified period of time. These assignable annuities are quite easy to sell and do not require a judicial review.

The second type of annuity is known as a non-assignable annuity or structured settlement. These types of annuities are funded by a single premium and are purchased to provide a predetermined payment stream to the payee and are typically the result of a lawsuit, injury settlement or wrongful death suit that has been settled. Selling this type of non-assignable annuity or structured settlement typically does require a judicial review.

For annuities purchased on a nonqualified basis, the assignment provision acknowledges the owner's right to assign his or her rights under the contract to another person any time during the deferral period of a deferred annuity. Once annuity payments begin, the rights of the parties to the contract are established by the payout option chosen. The assignment provision also removes the company's responsibility for any assignment made.

For annuities purchased to fund a qualified plan, the assignment provision states that the contract may generally not be assigned, except under certain conditions permitted by law (for example, as part of a domestic relations order issued by a court).

Annuities held under pension plans or owned as IRAs cannot be assigned or alienated, pursuant to Section 401(a)(13) of the Internal Revenue Code. Since these plans are for the benefit of employees, this protects the plan contributions from being garnished.

If an owner sells or assigns a qualified annuity contract, it will be considered as a distribution, subject to income tax and the pre-59½ penalty tax (if applicable).

**INCOME TAXATION ON DEATH OF OWNER**

The income tax treatment of an annuity upon the death of an owner (other than an entity), depends on whether death occurs prior to, or after, annuitization.

If the owner dies prior to annuitization, the following settlement options and their respective income tax implications.
If an annuity owner dies before the starting date of the annuity payments, the cash value of the contract must either be distributed within 5 years of death or used within one year of death to provide a life annuity or installment payments payable over a period not longer than the beneficiary’s life expectancy. However, if the surviving spouse is the beneficiary, the spouse can elect to assume the role of owner and continue the contract. In this instance, income tax implications have been delayed and the account may continue to grow tax-deferred.

The 10 percent premature distribution penalty tax does not apply to required after-death distributions. When the owner dies on or after annuitization, the beneficiary pays the income tax on residual payments that the insurer may be required to make. If the beneficiary continues the income stream, income tax is spread out over the remaining benefit period. If a lump sum is chosen, the beneficiary pays income tax on the portion of gain represented in the distribution.

In traditional and Roth IRAs using annuities, owner and annuitant are the same person. In qualified plans, the plan trust is the owner and the plan participant is the annuitant. In either case, when the owner/annuitant dies, the beneficiary pays income tax on the distributions as they are received. In qualified plans, at the death of the participant (annuitant), the distribution options available to the beneficiary are determined by the required minimum distributions rules.

If death occurred prior to receiving minimum required distributions, the beneficiary may choose either of the following:

1. Distribute the entire amount within five years after death of the owner; or
2. Distribute the entire amount over the beneficiary’s life expectancy provided such option is exercised within one year of the owner’s death; or
3. Spouse may assume ownership and continue the contract (if named as the designated beneficiary); or
4. If no beneficiary has been designated, the distribution occurs within five years of the owner’s death.

If death occurred after minimum required distributions began, the beneficiary may choose either of the following:

1. Distribute the remaining amount in lump sum provided such option is exercised within one year of the owner’s death; or
2. Distribute the remaining amount over the beneficiary’s life expectancy provided such option is exercised within one year of the owner’s death; or
3. Spouse may assume ownership and continue the contract (if named as the designated beneficiary)
4. If no beneficiary has been designated, the distribution occurs over the owner’s term certain life expectancy.

In either one of these circumstances, distributions are subject to income tax in the year they are received.

**TAXATION TO THE BENEFICIARY AT THE OWNER’S DEATH**

For a contract in deferral, federal tax law requires that any gain in the contract be recognized and consequent taxes paid whenever the owner dies. An annuity does not receive a step-up in value at the owner's death. This is also true in the event of multiple owners when any owner dies. Therefore, an annuity contract usually provides for payment of the death benefit to the beneficiary at the time of the owner's death. This means that the beneficiary is responsible for income taxes on the contract's gain.

Annuity gain is ordinary income, so the taxes on that amount will be computed based on the ordinary income tax rates in effect in the year of distribution. There is no capital gains tax break on the earnings.

**INCOME TAXATION ON DEATH OF ANNUITANT**

When the owner and annuitant are different people and the contract is annuitant driven, the contract dies when the annuitant dies. When the annuitant dies prior to the annuity’s starting date (annuitization), the beneficiary may elect to receive a lump sum distribution or choose a settlement option. Income tax treatment depends on which option is elected.

- **Lump Sum Distribution** - Ordinary income tax is due on all gain in the year of distribution.
- **Settlement Option** - Provided this election is made within 60 days of the annuitant's
death, taxable gain is spread over the settlement period. In this instance, an exclusion ratio will be calculated, providing tax-advantaged income.

If the annuitant dies after the annuity’s start date (annuitization), the beneficiary pays the income tax on any residual payments that the insurer is required to make.

One important exception occurs when the owner is a nonnatural person, such as a trust. In this situation, the annuitant’s death results in exactly the same tax treatment as the owner’s death.

Amounts payable under a deferred annuity contract at the death of an annuitant (prior to the contract’s maturity) will be taxed as ordinary income to the beneficiary. The excess of (a) the death benefit (plus aggregate dividends and other amounts that were received tax free) over (b) total gross premiums is taxable.

Beneficiaries can elect to delay reporting of the gain in the year of the annuitant’s death if the beneficiary applies the death benefit under a life income or installment option within 60 days of the annuitant’s death. The beneficiary will then report income according to an exclusion ratio. The beneficiary’s investment in the contract will be the same as the annuitant’s investment in the contract. The expected return is based on the income the beneficiary will receive and the beneficiary’s life expectancy.

Minimum Required Distributions

Under current regulations, the IRS requires all owners of qualified annuities (with the exception of Roth IRAs) to begin taking annual distributions by April 1 of the year after the owner reaches the Required Beginning Date at the age of 70½.

Minimum Required Distributions are calculated by dividing the ending account value of the previous year by a life expectancy factor. Distributions are usually calculated using the Uniform Lifetime Table which starts with a life expectancy of 27.4 years at age 70 and gradually decreases each year to 1.9 years at age 115.

### Uniform Lifetime Table

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<td>9.6</td>
<td>105</td>
<td>4.5</td>
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</tr>
</tbody>
</table>

Example: the annuitant is 74 years old. The value of his qualified annuity on December 31st of the previous year was $480,000. The factor from the uniform table is 23.80. The required minimum distribution for this year will be $20,168.06. Next year, the minimum required distribution will be based on the new value of his annuity and the life expectancy factor correlating to that of an individual one year older.

Owners of multiple IRAs are allowed to consolidate IRA accounts, allowing the MRD to be taken on the whole from any combination of accounts. 403(b) annuities can also be consolidated in a similar
manner. However, with other qualified plans, the MRD must be calculated and distributed from each plan separately.

**THE "EXCLUSION RATIO" FOR ANNUITIZED PAYMENTS**

The exclusion ratio for annuities purchased on a non-qualified basis arises from the idea that the payment consists of two parts: one part as-yet-untaxed earnings and one part premium upon which income taxes have already been paid. However, in a qualified plan annuity, taxes have not yet been paid on either the premium or the earnings, so the entire payment is taxable as income. (Note: In some cases, nondeductible contributions may be made to qualified plans, and an exclusion ratio can be applied to those nondeductible contributions.)

Annuitized income payments are taxed according to a concept known as the exclusion ratio. Part of each payment the annuitant receives is considered to be a return of principal, which is not taxed. The remaining portion of the payment, consisting of interest earnings, is taxable to the annuitant. The exclusion ratio determines the taxable and nontaxable portions of each payment according to the following formula:

\[
\text{Investment in the contract} \quad \frac{\text{Expected return}}{}
\]

The numerator of the fraction is the amount of the "investment in the contract." The denominator of the fraction is the total "expected return" under the contract. The periodic annuity payment is multiplied by this fraction to calculate the portion of the payment that is received tax free by the annuitant as a return of the investment in the contract. The balance of the payment is taxable to the annuitant.

The "investment in the contract" (also known as the annuitant's basis) is the amount the annuitant paid into the annuity in the form of premiums. The expected return is the total amount he or she will receive as income payments, based on the income option selected. The resulting ratio is the percentage of each benefit payment that is excluded from tax.

The excludable portion of any annuity payment may not exceed the unrecovered investment in the contract (unless the annuity started before January 1, 1987). (IRC Section 417(b).) The "unrecovered investment in the contract" is the policyowner's premium cost (reduced by any dividends received in cash or used to reduce premiums and by the aggregate amount received under the contract on or after the annuity starting date to the extent it was excludable from income). This rule limits the total amount the policyowner can exclude from income to the total amount of his contribution. Once an annuitant actually lives longer than his or her actuarial life expectancy, 100 percent of each payment will be taxable.

After the cost basis is fully recovered, payments received subsequently are taxable in full. If the participant dies before the cost basis is fully recovered, an income tax deduction for the unrecovered basis is allowed on the participant's final income tax return. If the annuity starting date was before November 19, 1996, different rules were applicable.

Since qualified plan annuities are generally purchased with premium dollars that have not yet been income-taxed, those premiums are taxable as income when they are paid out of the contract. As a result, exclusion ratio does not apply to income payments from a qualified plan annuity.

See IRS Publication 939, General Rule for Pensions and Annuities, for the details on how to calculate taxes due on annuity payments. (www.irs.gov)

**The Exclusion Ratio Can Help Reduce Tax on Social Security Income**

Seniors in particular can benefit from the power of an exclusion ratio. That is because too much taxable income can trigger additional taxes on Social Security benefits. If a client elected to withdraw interest from their annuity instead of annuitizing, 100% would have been reported as income, putting her Social Security benefits more at risk of being taxed.

Similarly, the exclusion ratio also helps by generating tax advantaged income during annuitization. Seniors could potentially minimize the taxation of Social Security benefits by choosing annuitization instead of using other taxable income sources.

**Taxes on Variable Annuity Payouts**

Annuity payments made as an annuity under a variable annuity are not subject to the same
exclusion ratio as is a regular fixed annuity. This is because it is impossible to determine the expected return. Instead, the following formula is used:

\[
\text{INVESTMENT IN CONTRACT} \times \frac{\text{NUMBER OF YEARS OF EXPECTED RETURN}}{100}
\]

**Estate Taxation**

The general rule is to include the value of an annuity in the taxable estate of a deceased owner only if the annuity provides for the payments to continue to a beneficiary after death. If all annuity payments cease upon the death of the owner, no value from the annuity is included in the beneficiary’s taxable estate.

For the non-spouse beneficiary, there is an itemized deduction equal to the estate tax paid by deceased annuity owner. For those situations where the annuity was part of a sizable estate, the deduction could substantially reduce the income tax liability to the non-spouse beneficiary. This deduction is called *Income In Respect To A Decedent*, or IRD.

The estate tax rules regarding annuities are fairly straightforward. If a contract owner dies before annuitization, the entire account value of the annuity is included in his or her gross estate for purposes of determining the estate tax. If the contract owner dies after annuitization has begun and payments continue to a beneficiary (under a term certain or survivor annuity), the present value of those future payments is included in the contract owner’s gross estate. If the annuitization was under the life-only option, there is no value for estate tax purposes because payments cease at the contract owner’s death.

A decedent’s right to a payment is sufficient. The decedent need not have actually received or be receiving payments by the date of death, nor must the time at which payments would commence have passed by the date of death.
QUALIFIED PLANS AND ANNUITIES

A good place to start investing for retirement is with employer-sponsored retirement plans. Among these plans are defined contribution plans, such as the 457, the 403(b), and perhaps the most familiar, the 401(k). If the employer offers a retirement plan, employees should seriously consider participating in it, as it is one of the easiest and most beneficial means of helping to save for retirement. It is also one of the best ways to defer paying taxes on the investments.

Many working people have the opportunity to save toward retirement through their employment. According to the Bureau Of Labor Statistics in 2000, 79% of private sector employers with 100 or more employees offered retirement plans.

Employers have several choices for qualified plans such as: SIMPLE, SEP, Profit Sharing, Keogh and others. Generally, the plans available to employers fall into one of these two-categories:

- **Defined Benefit Plans** - These plans promise to pay a guaranteed income benefit upon retirement.
- **Defined Contribution Plans** – Under these plans, the employer contributes funds that the employee can withdraw upon retirement. 401(k) plans are an example of a defined contribution plan.

THE BENEFITS OF QUALIFIED PLANS

Qualified plans offer many advantages to Americans who want to save for their retirement.

- Earnings on contributions accumulate tax-deferred until distributions begin.
- All individual plans (except Roth IRAs) and employee contributions to employer-sponsored plans allow contributions to be funded with pre-tax dollars.
- Most qualified plans allow investors to change the amount of contributions made yearly, to account for changing financial circumstances.
- A variety of different financial instruments including stocks, bonds, mutual funds and annuities may be used to fund qualified plans.

Qualified plans are intended (receive tax-preferred treatment) as long-term investments. Qualified plans in general, are subject to the following restrictions:

- Contributions made to qualified plans are deductible up to specified limits. These limits are dictated by the plan and typically change yearly. Exceeding the plan's maximum contribution limits, usually carries penalties.
- 100% of the distributions from most qualified plans are subject to income taxation. Additionally, a penalty tax may apply if funds are accessed prematurely. The amount of tax varies depending on the plan type. Under specific circumstances the IRS will waive the penalty tax.
- At some point, the IRS requires that a minimum distribution must be taken from qualified plans. For employer-sponsored plans, distributions are generally required beginning April 1 of the year following retirement or age 70½, whichever is earlier. All other plans require distributions to begin April 1 of the year after the owner reaches age of 70½.

Non-qualified annuities receive the benefit of tax-deferred growth. However, when dealing with working-aged adults, agents should evaluate the client's employer-sponsored options before recommending a non-qualified annuity since many employers match employees' contributions.

INDIVIDUAL RETIREMENT ACCOUNTS

Individual Retirement Accounts have been around since 1974 when they were introduced as part of the Employee Retirement Income Security Act (ERISA). Individual Retirement Accounts (IRAs) provide Americans with a tax advantaged way to some for retirement. They are available to anyone who receives taxable compensation during the year, with some exceptions, IRAs are not part of the employer-sponsored plan marketplace.

With a traditional IRA, the owner can no longer contribute to the IRA once reaching the age of 70½. Additionally, minimum required distributions must begin at age of 70½ as well.
IRAs represent a sizable potential source of annuity business. Generally, anyone who has earned income is eligible to establish an IRA, regardless of whether he or she is able to deduct the contribution. Many individuals have opened IRAs for their regular retirement savings. In addition, many individuals are receiving large lump-sum distributions from employer-sponsored retirement plans, either as a result of a layoff or early retirement. By rolling these distributions into an IRA, individuals can continue to defer taxes on these amounts.

Some financial analysts object to funding IRAs with annuities since both IRAs and annuities provide tax-deferral on earnings. Since the IRA is tax-deferred, buying a tax-deferred product to fund it seems "redundant." Clients who fund IRAs with annuities, say these analysts, are paying for a feature they don't need.

But tax-deferral in an annuity doesn't "cost" the client anything. There's no charge for it. It's simply part of the tax code. Death benefits, safety, performance, tax-deferral, the option to purchase an income stream guaranteed to last for life—there are many good reasons to purchase annuities, inside or outside of an IRA.

Most IRAs allow people to direct how funds in their account are invested. They may be able to invest the funds in a variety of ways, including individual stocks and bonds, annuities, and mutual funds, though there are some restrictions on how IRA funds are invested, for example life insurance policies cannot be used to fund a IRA. There are two types of IRAs - traditional and Roth. There are several basic differences between a traditional IRA and a Roth IRA.

**Traditional IRA**

The earnings on any IRA are taxed-deferred. Depending on how much money they earn, people may also be eligible to deduct their IRA contribution from their gross income for tax purposes. But, there are penalties for withdrawing money from a traditional IRA before they reach the age of 59½, and withdrawals will be taxed as ordinary income.

Under a traditional IRA:

- Contributions might be deductible
- Earnings are not subject to income tax in the year earned
- Distributions of contributions and earnings are generally income taxable

<table>
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<th>Year</th>
<th>Normal Limit</th>
<th>Catch-Up Bonus (if age 50 or older)</th>
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<tr>
<td>2008</td>
<td>$5,000</td>
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**Roth IRA**

This type of IRA was named after former Senator William Roth of Delaware, who championed the Taxpayer Relief Act of 1997. Eligibility is determined by the amount of annual income. Participants may not deduct contributions to Roth IRA from taxable income, but growth in a Roth IRA is tax-free.

Under a Roth IRA:

- Contributions are not deductible
- Earnings are not subject to income tax in the year earned
- Distributions of contributions and earnings generally are not income taxable.

The Roth IRA has some advantage over a traditional IRA - earnings are not only tax deferred, they can be tax-free, provided the distributions are qualified.

If someone has had their Roth IRA for more than five years, they may usually withdraw earnings from their Roth IRA without paying penalties and/or taxes, if: they have reached the age of 59½, they become fully disabled, or they are using the money to buy their first home ($10,000 life-time limit). They may also withdraw funds from a Roth IRA to pay for college, however taxes will be due on that withdrawal. They will not be subject, however, to the penalty for premature withdrawal.

In some cases, contract owners may convert a traditional IRA to a Roth IRA, but they must pay income taxes on the converted amount that was not previously taxed. As with any retirement investment, they should consult a financial professional to learn all the details before making the conversion.
The owner of a Roth IRA can continue making contributions well past age 70½ (as long as they have earned income) with no requirement for distribution. A Roth IRA owner could defer distributions until death.

Comparing a Traditional IRA to a Roth IRA

<table>
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<th>Roth</th>
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<tr>
<td>Contributions must cease at age 70 ½</td>
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<tr>
<td>Minimum required distributions at age 70 ½</td>
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<td>No</td>
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<tr>
<td>Tax-free distributions</td>
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EMPLOYER- SPONSORED PLANS

TYPES OF DEFINED CONTRIBUTION PLANS

401(k) Retirement Plans

401 (k) retirement plans are the most popular of all defined contribution plans available. 401 (k) plans offer Americans a savings vehicle featuring a diverse cross-section of investments from which to choose, including mutual funds and variable annuities, as well as other specialized investment funds. Employees are permitted to use pre-tax earnings to make contributions to 401 (k) plans. If they change jobs, the existing 401 (k) plan can be rolled into a new plan. Employers commonly match employees’ contributions as an employee benefit.

The 457 plan, offered only to state and local government employees, allows employees to set aside a portion of pay for use later--generally in retirement. Participants are not taxed on that income now; pay taxes later, when withdrawing the money from the plan. A 457 plan reduces current income taxes, while helping save for retirement, and allowing earnings to accumulate tax-deferred.

In 2006, participants in 401 (k) plans may defer up to $15,000 in income to a 401 (k) plan. For individuals 50 years or older, a special "catch-up" contribution provides for an additional contribution of $5,000 in 2006.

403(b) Retirement Plans

A 403(b) plan is similar to a 401(k), but is offered to employees of public and private school systems--K through college--and non-profit, tax-exempt organizations, such as churches, libraries, etc.

Also known as tax-sheltered annuities, 403(b) retirement plans provide tax-deferred savings to employees of public educational systems and select non-profit charitable organizations. They are similar to 401(k) plans since pre-tax earnings are withheld from the employee’s paycheck. The employer sponsors 403(b) retirement plans but employer contributions are not required.

In 2006, participants in 403(b) plans may defer up to $15,000 in income to 403(b) plans. For individuals 50 years or older, a special "catch-up" contribution provides for an additional contribution of $5,000 in 2004. "Catch up" provisions also apply under special circumstances.

403(b) contains unique loan provisions that can avoid taxation when the contract owner exercises a loan. If the contract owner adheres to strict guidelines and be paid back systematically. Failure to comply with the guidelines set forth by the IRS may force the insurer to report the loan as a distribution. If this happens, tax consequences apply.

Contributing to a 401(k) is simple; the employer deducts the amount designated from the pay, before federal taxes. The amount contributed to the plan lowers their taxable income. In many companies, the employer matches all or part of the contribution.

The employee usually gets to choose how much they want to contribute within the restrictions of the particular plan; however, the employer or its plan administrator will manage the account. Many 401(k) plans also allow people to direct how the funds are invested within the choices allowed by the plan.
Simplified Employee Pensions - SEP Plans

A SEP plan looks like a basic profit-sharing plan. Each year the employer can make tax-deductible contributions based on a percentage of an employee's compensation into a traditional IRA set up by the employee. All employees must receive the same percentage, although no employee can receive more than $44,000 in 2006. The employer has a great deal of flexibility because each year, a new contribution level can be chosen. If times are difficult, contributions may be skipped altogether. The maximum contribution (and employer income tax deduction) to a SEP plan is the lesser of 25% of the employee's compensation or $44,000.

Saving Incentive Match Plans for Employees - SIMPLE Plans

A SIMPLE account looks more like a 401(k) account. It was designed for employers with less than 100 employees (excluding earners who made less than $5,000 the previous year). SIMPLE plans may be structured as either a SIMPLE IRA or a SIMPLE 401(k). In either approach, the employer is required to match employee contributions using criteria set forth by the IRS.

In essence, employees elect to defer some of their salary into a traditional IRA. Like other elective deferral accounts, the amount that employees can defer is increasing. In 2006, an employee may defer up $10,000 in a SIMPLE plan. Additionally, "catch-up" provisions also apply to employees age 50 and older, increasing the maximum amount of elective deferral to $12,500 this year.

THE ANNUITY MARKET AND BUYER DEMOGRAPHICS

A survey conducted by the Life Insurance Marketing and Research Association (LIMRA) suggests that two-thirds of annuity contracts are purchased by individuals 45 years old or older (the average age is 58) and the average annuity purchase is around $30,000. While these statistics differ from company to company, they give us a general picture of the typical annuity buyer.

Today, we know that the average age of fixed/indexed annuity buyers is about 63, while the average age of variable annuity buyers is 48. Since safety of retirement assets becomes more important than growth as seniors age, the focus tends to shift from accumulating assets to protecting them. Because fixed and equity-indexed annuities are not subject to principal risk, seniors tend to purchase them more frequently than variable annuities.

Purchasers of annuities when asked to select the most important reason for buying their annuity most often identified saving for retirement, guaranteeing retirement income, tax-deferred savings, and the potential for investment growth.

Besides products features, other factors affect buying behavior as well. More than 80% of the people who purchased variable or fixed annuities said the financial stability of the carrier was an important factor influencing purchase, as was the reputation of the carrier issuing the annuity. Another significant factor was the expertise and knowledge of the sales representative.

According to LIMRA’s Deferred Annuity Buyer Study, completed in late 1998 and based on 42,173 people who purchased individual deferred annuities in 1997, individuals age 65 and older purchased over half of all nonqualified contracts. The same study shows that life insurance agents sold 91 percent of the 403(b) contracts. Life agents and non-agent distribution systems evenly split IRA sales. Stockbrokers, banks and other non-agent systems, made however, nearly two-thirds of the nonqualified contracts sales.
PRIMARY USES OF ANNUITIES

Traditionally, annuities were used almost exclusively as a means to generate fixed income streams that could not be outlived. Immediate annuities are designed specifically for this application. Before the 1970s, immediate annuities accounted for well over 90 percent of annuity sales. Today, they account for less than 20 percent. The popularity of the immediate annuity has been replaced by the deferred annuity for a variety of reasons:

- Consumer need for capital accumulation and growth;
- Consumer desire for tax deferral;
- Deferred annuity product designs that allow for greater flexibility and liquidity than previously available; and
- The growth of the equities market and the appeal of variable annuities.

Planning ahead for a comfortable retirement requires a diligent savings approach. In light of longer life expectancies, rising healthcare costs, and a concern over the viability of Social Security, most Americans aren’t saving enough for retirement. The risk of outliving our retirement funds is very real.

Because of their unique tax treatment, annuities provide Americans with two distinct retirement benefits: planning tax-deferred savings and the ability to create an income stream that cannot be outlived. In the LIMRA Deferred Annuity Buyer Study of 1999, buyers cited the most important reasons for buying annuities as:

- Easy Way To Save For Retirement
- Provide Guaranteed Monthly Income In Retirement
- Help Pay For Children/Grandchildren’s Education
- Emergency Fund for Catastrophic Illness/Nursing Care
- Build An Inheritance
- Avoid Financial Burden On Children
- Investment with Growth Potential
- Tax-Deferred Savings

THE ANNUITY AS AN INCOME VEHICLE

Either deferred or immediate annuities can provide an income stream that cannot be outlived.

Findings of an April 2003 American Council Of Life Insurers (ACLI) research report on immediate annuity buyers validates the importance of annuitization for an aging America.

- 71% of immediate annuity buyers purchased a life settlement option.
- 86% of buyers who selected a life settlement cited having an income that could not be outlived, as very important.
- 22% of buyers cited their purchase as one of the best financial decisions they ever made. Another 60% said it was a good decision.
- 92% of annuity buyers report receiving Social Security income and 60% report receiving dividends and interest.
- Almost two-thirds of buyers do not receive income from a defined benefit pension and have created their own pension plan by purchasing annuities.

For older people, annuitization supplements other sources of income like Social Security and pension income. It may even help reduce income taxation of a senior’s Social Security benefits.

Chances are Social Security and pensions won’t be enough to pay for the retirement most people have in mind. Even if they contribute to a 401(k) plan and an IRA, they may come up short later in life. With increasing life expectancies, retirement could last 30 years or longer. Plus, the effects of inflation will erode purchasing power throughout the retirement years. Considering all of these challenges, how can people reach their retirement income goals?

Annuities are long-term vehicles specifically designed to supply retirement income. They can supply retirement income that cannot be outlived. With annuities, there are no IRS imposed annual contribution limits and any earnings grow tax-deferred until they are withdrawn or annuity income payments begin.

Many options are available when the time comes to start drawing income from the annuity, including
payments guaranteed for life. Annuities can also offer liquidity and an opportunity to keep up with or outpace inflation. Withdrawals may be subject to surrender charges and, if taken prior to age 59 ½, withdrawals of earnings are subject to ordinary income tax to the extent of gain and a 10% federal income tax penalty may also apply.

WHEN TO USE ANNUITIES

Some form of annuity would be useful in the following circumstances:

1. When a tax deferred accumulation of interest is desired. The interest earned inside an annuity owned by an individual grows income tax free and is not taxed until it is withdrawn.
2. When liquidity is desired. Owners may usually withdraw cash, within limits, before the annuity starting date.
3. When an investment with immediate and high collateral value is needed.
4. When a person wants a retirement income that can never be outlived.
5. When the person would like to avoid probate and pass a large sum of money by contract to an heir to reduce the possibility of a will contest.
6. When an investor wants to be free of the responsibility of investing and managing assets.
7. As a replacement for, or an alternative to, an IRA. With less opportunity for pre-tax contributions to IRAs, many clients are seeking opportunities of making regular after-tax contributions to an investment vehicle. The annuity may be a good choice because the contribution can be much more than the IRA limitations.
8. When a retired individual wants a monthly income equal to or higher than other conservative investments and is willing to have principal liquidated.
9. Fixed annuities, in particular, would be indicated:
   - when safety of principal is a paramount consideration. This is particularly important for retirement planning;
   - when an investor wants a guarantee that a given level of interest will be credited to his investment for a long period of time; and
   - when a conservative complement to other investment vehicles is desired.
10. Variable annuities, in particular, would be indicated:
   - when an investor wants more control over his or her investment and is willing to bear the risk associated with his or her investment selections;
   - when a person is looking for potentially increasing retirement income.

THE ANNUITY AS AN ACCUMULATION VEHICLE

We have already discussed tax-deferral of earnings several times in the course it is perhaps the single greatest benefit of the annuity. Unlike other investments, such as certificates of deposits and mutual funds, the earnings in an annuity are not subject to ordinary income taxes until they are withdrawn. This gives the annuity owner control over when earnings are taxed.

The first thing that comes to mind when discussing deferred annuities is the fact that the income earned on the funds within the contract is not subject to current taxation. Only when funds are withdrawn are the earnings taxed. This greatly enhances the product's ability to build assets for the long term.

In exchange for tax deferral, the annuity must be used as a long-term product whose values are reserved for retirement. If funds are accessed earlier, they may be subject to a tax penalty.

Tax-deferred means postponing taxes on interest earnings until a future point in time. In the meantime contract owners earn interest on the money they're not paying in taxes. Clients can accumulate more money over a shorter period of time, which ultimately will provide a greater income.
Because taxes are not paid on earnings every year, an annuity is able to work harder thanks to tax-deferral. Taxes will eventually have to be paid on earnings when the annuity's gains are withdrawn.

NO taxes are paid while the money is compounding. A lower tax is also paid on random withdrawals because clients control the tax year in which the withdrawals are made, and only pay taxes on the interest withdrawn. Tax deferral provides control over an important expense -- taxes. The longer this particular expense can be postponed, the greater the gain when compared to the gain on a fully taxable account.

To illustrate the increased earnings capacity of tax-deferred interest, compare it to fully-taxable earnings. $25,000 at 6.0% will earn $1,500 of interest in a year. A 28% tax bracket means that approximately $420 of those earnings will be lost in taxes, leaving only $1,080 to compound the next year. If these same earnings were tax-deferred, the full $1,500 would be available to earn even more interest. The longer taxes can be postponed, the greater the gain.

**Tax-Deferred Vs. Fully Taxable**

*Compare the Return*

$107,297 Accumulated in a Tax-Deferred Annuity  
$71,966 Accumulated in a Taxable Account  
The Difference: $35,331

In general, tax-deferral on earnings does not extend to annuities owned by "nonnatural persons," such as corporations, although there are some exceptions. Only the following nonnatural persons can obtain the benefit of tax-deferral on deferred annuities:

- Estates of deceased individuals
- Qualified pension, profit-sharing, stock-bonus, 403b, or Individual Retirement Account (IRA) plans
- Trusts established for the benefit of a natural person
- Premiums paid for annuities before February 28, 1986.

**DEFERRED ANNUITIES CAN HELP REDUCE TAXATION OF SOCIAL SECURITY BENEFITS**

For seniors a tax-deferred annuity also can help reduce the taxation of Social Security benefits. Social Security benefits are subject to income tax if provisional income levels exceed the thresholds set by the IRS. Provisional income typically includes adjusted gross income, tax-exempt income, and 50% of Social Security benefits. For comparison, income from investments can't do much to avoid the taxation of Social Security benefits when income exceeds the thresholds.

**UNDERSTANDING TAXABLE VS. TAX DEFERRED VS. TAX-FREE**

Returns on investments may be taxable, tax-deferred, or tax-free. It is important for agents to be able to explain the difference between these and especially to be able to assist clients in determining which investment provides the best return after taxes.

- **Taxable** investments, such as CDs and money market accounts, earn interest that is taxed each year, whether or not the insured withdraws funds.
- **Tax-deferred** investments, like annuities, earn interest that is not taxed until withdrawn.
- **Tax-free** investments, like municipal bonds, earn interest that is not subject to income tax at all.

Agents and consumers need to understand that choosing the annuity with highest rate doesn't always result in the highest return.

Since tax-advantaged investments tend to have lower pre-tax yields than taxable investments, it is important to convert a taxable yield into an after-tax yield so that consumers will be able to compare products and make an informed decision.
CALCULATING THE TAX EQUIVALENT YIELD

Converting tax-advantaged yields to taxable equivalent yield is really very simple. If you know the rate of return on a currently taxable investment, the following formula will allow you to determine the rate of return on an after-tax basis:

Before-tax return \times (1 - \text{Tax bracket}) = \text{After-tax return}  

long term effect of tax-deferred compounding vs. other available investment choices

Income distributions

Often an individual does not want to commit to a lifetime payout option. He or she may wish only to take income for a period of time, then reevaluate his or her economic situation and risk tolerance as well as economic conditions in general.

In addition to guaranteed monthly income, one may also make a partial withdrawal from the deferred annuity. However, it is important to keep in mind the IRS may impose a 10% penalty on withdrawals before age 59½ except under certain circumstances.

UNDERSTANDING THE SPLIT ANNUITY CONCEPT

Split funded annuities are a comparatively recent development, whereby an immediate annuity and a deferred annuity are combined to accomplish specific financial objectives, including the following:

- Conserving principal
- Maintaining flexibility
- Receiving income
- Providing tax advantages

Split-funding can be useful for people who have a need to generate spendable income over a certain number of years, but also want to preserve their capital.

A Split Annuity is not an annuity policy but a combination of two annuity products. A single premium immediate annuity and a single premium tax deferred annuity structured in such away as to produce immediate income for a guaranteed period of time and to restore the original principal at the end of that time period.

- A Deferred Annuity is used to restore the original principal at the end of the guaranteed period.
- The Immediate Annuity provides a guaranteed monthly income for the same time period.
The immediate annuity is used to generate an income stream that is guaranteed not to change for some period certain, typically 5 to 10 years. And, if non-qualified funds are used, only the interest income portion of the immediate annuity will be subject to income taxes, creating tax-advantaged income.

**Advantages of a Split Annuity**

- **Dependable Income**: The Immediate Annuity supplements income by providing a safe, predictable, and guaranteed cash flow. Depending on income needs, the Immediate Annuity can generate a stream of monthly income anywhere from five to twenty years.

- **Tax-Advantaged Income**: Since a significant portion of monthly income from the Immediate Annuity is considered a return of the original investment, it is tax-advantaged.

- **Tax-Deferred Growth and Principal Preservation**: The Deferred Annuity portion of the split-annuity concept offers tax-deferred growth and an interest rate that historically has been higher than average CD rates. In addition, original principal is restored at the end of the guaranteed period.
Example of a Split Annuity

The illustration is based on a guaranteed interest rate of 6.25% for 8 years. Withdrawals from an annuity prior to age 59½ may result in a 10% penalty tax imposed by the IRS.

<table>
<thead>
<tr>
<th>Immediate Annuity</th>
<th>Deferred Annuity</th>
</tr>
</thead>
<tbody>
<tr>
<td>$38,430 at 6.2%</td>
<td>$61,570 at 6.25%</td>
</tr>
</tbody>
</table>

Monthly Income

| $485.37 |

Annual Income

<table>
<thead>
<tr>
<th>$5,824.48 for 8 years for which 82% is not taxed Total Income before Taxes</th>
</tr>
</thead>
<tbody>
<tr>
<td>$46,595.83</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Yr. 1 $65,418</th>
<th>Yr. 2 $69,507</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yr. 3 $73,851</td>
<td>Yr. 4 $78,466</td>
</tr>
<tr>
<td>Yr. 5 $83,371</td>
<td>Yr. 6 $88,581</td>
</tr>
<tr>
<td>Yr. 7 $94,118</td>
<td>Yr. 8 $100,000</td>
</tr>
</tbody>
</table>

Starting with an investment of $100,000, a "split" annuity can be created that will:

- Provide an annual, fixed income for a specified period of time.
- Renew itself within the same specified period of time.
ANNUITIZATION OPTIONS

Whether deferred or immediate, annuities offer a variety of settlement options to help achieve different income needs. An annuity can be used to create an income stream, whether immediate or in the future. The liquidation of a principal sum based on certain contingencies including the duration of the income stream (term, life or a combination of the two) and its investment basis (fixed or variable). Alternatives to annuitization, including surrender and systematic withdrawals, are also available.

The origin of the annuity is based on a fairly simple mathematical concept: a lump sum of money, invested today at a certain rate of interest, can be converted, or "annuitized," into a series of periodic payments, calculated to extend for a specific period of time. The basic factors are principal, interest and time. Each periodic payment consists partly of amortized principal and partly of interest earnings.

Annuities can play an important role in any situation in which a guaranteed stream of income is needed, especially during retirement. The application of the annuity principle allows individuals to enjoy their retirement years with income they can't outlive. This has brought peace of mind to countless numbers of investors. As longevity continues to increase and individuals begin to live 20 to 30 years (or more) past retirement, a major financial concern is the very real possibility of outliving one's assets. An annuitized income stream guaranteed for as long as an individual lives, addresses this concern.

FIXED VS. VARIABLE INCOME

The choice of a fixed or variable income stream boils down to a choice between the safety of guaranteed fixed-dollar payments or the potential for payments that increase with inflation. Fixed annuitization is a sure, safe means that produces a dependable income stream, but it is subject to erosion by inflation. Variable annuitization provides an income stream that may fluctuate, based on the investment performance of the accounts in which the annuity is deposited. As costs rise, the potential exists for increased income payments, but there are no guarantees.

VARIABLE ANNUITIZATION

Under variable annuitization, an income amount is set at the point of contract annuitization, but it may change based on the market performance of the investment options in which the contract's funds are invested. Variable annuitization offers the potential for a rising income that could keep up with-or outpace-inflation, but the possibility that a decline in the market could lower the income payments.

Income is be structured to fluctuate with the value of the underlying separate account assets. By linking the annuity payments to separate account investments of stocks and bonds, the annuitant's income should adjust for inflation, rising with increases in the cost of living and declining if and when prices fell.

THE ASSUMED INTEREST RATE

Variable annuitization is accomplished with the selection of an assumed interest rate (AIR) and the allocation of the annuity fund to one or more separate account investment funds. The insurance company then converts the money in the contract owner's account into an initial payment, based on the AIR and payout period desired (term certain or life). The final step is to convert the initial payment into annuity units based on their value at the time of the first distribution. The resulting number of units is then used to calculate each future payment for the balance of the payout period or the term of the contract. The number of units remains constant; but the value of the units varies based on the performance of the underlying investments.

The AIR is the rate of interest or the rate of investment growth that is assumed or projected for the contract's future performance. It is used as a benchmark against which the contract's actual return is measured. If the actual return exceeds the AIR, the annuitant the payment amount increases. If the actual return is less than the AIR, the payment amount decreases. For example, assume a contract's AIR is 5 percent. If the accounts in which the contract's funds are invested increase at exactly 5 percent (net of mortality and expense charges), the annuity payment amount remains level. If actual fund performance is less than 5 percent, the annuity payment amount decreases; returns greater than 5 percent leads to an increase in annuity payments.
ANNUITY PAYOUT DEFINITIONS

An annuity stream can be structured for the duration of a person’s life, a specified term of years or a combination of both. A straight life or life-only annuity pays a benefit for the individual’s life, no matter how long or short a period that may be. At the annuitant’s death, income ceases. A term certain annuity pays benefits for a specified period of time, such as 10, 15 or 20 years, without regard to a life contingency. A combination of life with term certain annuity pays an income for the life of the annuitant, but guarantees a minimum number of monthly payments, such as 120 (10 years) or 240 (20 years).

**Life Only**

Relative to payout options based on a life contingency, the life-only option produces the largest amount of income per dollar of principal. For a $100,000 premium, a life-only annuity option would produce $789 of income per month for the annuitant’s life.

<table>
<thead>
<tr>
<th>Guaranteed income for as long as the annuitant lives</th>
<th>Death occurs/Income ends</th>
</tr>
</thead>
</table>

While life only settlements contain the greatest risk, they also deliver the highest benefit of all life settlement options. This payment option usually pays the highest income possible. Clients might choose it if they have no dependents, if they have taken care of them through other means, or if the dependents have enough income of their own. Often, life agents who utilize this option create a standalone tax-free death benefit by purchasing a life insurance policy with part of the proceeds.

The risk of life only settlements is that if the annuitant dies before the investment has been returned, the insurance company pockets the remainder. For this reason, most insurers allow a period certain benefit to be added to life settlement options. This assures if premature death occurs within the stated period certain the beneficiary would continue to receive the income stream for the balance of the period certain.

**Life Annuity With Term Certain** -- Payments are guaranteed for the life of the annuitant until the date of death. If the period certain has not expired at the time of death, payments will continue to the beneficiary for the remainder of the guaranteed period.

<table>
<thead>
<tr>
<th>Guaranteed income for as long as the annuitant lives</th>
<th>Death occurs</th>
<th>Income continues until the end of the guarantee period</th>
</tr>
</thead>
</table>

when the first one dies. No payments continue after the death of either annuitant. This type of payout option is rarely used.

**Pure Joint Life**

A pure joint life payout option provides a specified income amount for two people, but payments stop
Joint And Survivor

Joint & Survivor -- Payments are guaranteed based upon two lives, usually a husband and wife. Full income payments continue until the first death with full or partial payments continuing until the survivor’s death at which time payments cease.

- Guaranteed income for as long as both annuitants live.
- Death occurs
- Income continues at full or partial level
- Death occurs/Income ends

This option can be arranged in a number of ways. At the time this option is elected, the benefit may be structured to remain the same upon the death of the first annuitant or it may be reduced. For example, a joint life and 100 percent survivor payout provides a certain income benefit to both individuals and, at the death of the first, continues the same payments to the survivor as long as he or she lives. A joint life and 50 percent survivor payout provides income payments to two people and, upon the death of the first, makes payments to the survivor equal to half the amount of the initial payments, as long as the survivor lives.

For $100,000, a joint life and 100 percent survivor option would yield $664 per month whether one or both are alive. A joint life and 50 percent survivor option would generate $708 per month while both are living and continue payments of $354 to the surviving annuitant after the first annuitant’s death. By adding the life expectancy of another annuitant, this generates lower income since the insurer is now contractually obligated to make payments over multiple lives.

A joint life and survivor option also can include a term certain guarantee. For example, a joint life and survivor payout with a 10-year certain option provides income payments to two individuals and guarantees that if both deaths occur within the first 10 years, payments will continue to a named beneficiary for the remainder of the 10 years. Of course the more guarantees the lower the income payments.

**TYPES OF JOINT & SURVIVOR ANNUITIES**

- Joint & Full Survivor (100%): Level payments are made for as long as either the annuitant or joint annuitant is alive.
- Joint & Survivor (50%...75%) reducing on first annuitant’s death: Full level payments are made as long as both the annuitant and joint annuitant are alive. Upon the death of either the annuitant or joint annuitant, reduced (50%...75%) level payments will continue to the survivor for as long he/she is alive.
- Joint & Survivor with Period Certain: If both the annuitant and joint annuitant die before the end of the certain period, full level payments will be paid to the designated beneficiary until the end of the certain period.

**Period Certain**

**Period Certain Annuity** -- The individual chooses a number of years, such as five or ten, and payments are spread equally over that period. Payments cease at the end of that period even if the individual is still alive at that time. If the individual dies before the end of the term, the remaining payments are made to a beneficiary. With $100,000 a 5-year term certain option would result in a monthly payment of $1,802; a 10-year certain option would provide $1,077 monthly.

The period certain option is usually available for periods of 5, 10, 15 or 20 years. The longer the guaranteed period, the smaller the amount of each benefit payment. A life with 10-year certain payout for $100,000, would result in a monthly benefit of $737.

Period certain settlements provide a reliable way to fund finite needs. They may be used to generate additional income, for specific time frames. Unfortunately, this approach does not produce an income stream that lasts a lifetime.

**Fixed Amount Annuity** -- Also called "installment certain" payout option, the individual chooses the payment amount, and payments of that amount are made regularly until all annuity funds are

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exhausted. As under the "term certain" option, payments cease when the funds run out even if the individual is still living at that time. If the individual dies before the funds are exhausted, the remaining value is paid to a beneficiary. This payout option might be useful when a steady income of a fixed amount is the highest priority.

Refund Annuities

This option is designed to guarantee the return or refund of the annuity's principal if the annuitant dies before the amount he or she paid into the contract is fully liquidated. It can take two forms: installment refund or cash refund. Under either option, if the annuitant lives to receive payments equal to the principal amount, no future payments are made to a beneficiary. An installment refund option would generate $723 a month for a $100,000 annuity; a cash refund option would pay out $714 monthly.

Installment Refund

Installment refund provides beneficiary protection through the continuation of installments. Level payments are received for the annuitant’s lifetime. However, if the annuitant should die before receiving an amount equal to the original premium, the periodic payments will continue to be paid to the designated beneficiary until the total payments made (annuitant and beneficiary) equal the original premium.

Cash Refund

Payments continue for life. However, if the annuitants die before the initial deposit is recovered, a lump sum payment equivalent to the remainder of the initial deposit is refunded.

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Advantages and Disadvantages of Annuitization

The primary advantage to annuitization is a structured, guaranteed income flow for the duration of the specified period, whether it's a certain number of years or life. Each month or quarter or year, the insurer promises to make guaranteed payments of principal and interest to the annuitant.

Especially for those in retirement, a fixed annuity payout provides a certain, known income that will not change.

On the other hand, the primary disadvantage of annuitization is usually irrevocable. Because the contract owner has converted his or her funds to a distribution mode, he or has probably forfeited any rights to the underlying account balance. The contract owner cannot change the income stream during life. A fixed annuitized payout option commits the annuitant to an income flow and the methodical liquidation of his or her principal. Also, the rates of return on annuity income options are fixed at the point when the contracts annuitize and typically are not very high relative to current interest rates. Fixed annuity payouts in particular offer very little protection against inflation.

There is a significant rate of return impact if the annuitant (and his or her survivor) die before life expectancy. These returns are increased if the annuitant and his or her survivor live beyond life expectancy. This compares the relative payout for various annuity options starting with $100,000:

<table>
<thead>
<tr>
<th>Payout option</th>
<th>Amount of Monthly Payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Life only</td>
<td>$789</td>
</tr>
<tr>
<td>Life only with 10-year certain</td>
<td>$737</td>
</tr>
<tr>
<td>Joint life and 50 percent survivor</td>
<td>$708</td>
</tr>
<tr>
<td>Joint life and 100 percent survivor</td>
<td>$664</td>
</tr>
<tr>
<td>Joint life and 50 percent survivor with 10-year certain</td>
<td>$698</td>
</tr>
<tr>
<td>Joint life and 100 percent survivor with 10-year certain</td>
<td>$663</td>
</tr>
<tr>
<td>Five-year certain</td>
<td>$1,802</td>
</tr>
<tr>
<td>10-year certain</td>
<td>$1,077</td>
</tr>
</tbody>
</table>

The Tax Ramifications of Annuitization Options

Non-qualified annuitization options

When non-qualified annuities pay out under annuitization each payment is partially taxable and partially nontaxable due to the exclusion ratio. Payments that are considered “withdrawals” will be taxable just as income and, when all income has been paid out; the remainder will be a “taxable-free” return of the premium. When the beneficiary receives the proceeds after the death of the annuitant/owner the beneficiary will be liable for income taxes on the amount of the annuity which is in excess of the premiums paid in. A spouse will be able to continue the annuity as owner and continue to defer taxes. No annuity distribution qualifies for capital gains tax treatment.

Qualified annuitization options

Since premiums paid for qualified annuities have never been taxed, the entire amount of any distribution would be taxable at ordinary income tax rates.
ADVANTAGES & DISADVANTAGES OF ANNUITIES

Beyond tax advantages, there are important reasons to invest in an annuity, especially compared to the limitations of other types of investments. For example, annuities can provide:

- **No risk of loss** ("fixed" annuity), unlike other forms of stock or fund investments, annuities include minimum guarantees to limit the amount of investment risk.
- **No-penalty rollovers.** Company pension or profit-sharing plan payouts may be reinvested without incurring current taxes or penalties.
- **No probate in case of death,** as long as beneficiaries are specified by the contract owner.
- **Shelter investment earnings.** Retired people can use annuities to shelter investment earnings that would otherwise lead to taxation of their Social Security benefits.

The Advantages of Annuities

**Tax-Deferral**

Because the interest on an annuity is tax-deferred, an annuity paying the same rate of interest (after expenses) as a taxable investment will result in a higher effective yield.

Fixed, equity-indexed and variable annuities all receive special tax treatment by the IRS, allowing earnings to be deferred until withdrawn. This is a benefit for all age groups, young and old.

For people under the age of 60 a flexible premium deferred annuity provides a systematic way to supplement employer sponsored retirement plans where cash values accrue quicker due to tax referral. This could mean even greater tax savings if the client's tax rate decreases at retirement.

For people 60 years and older an advantage is that annuity earnings aren't subject to income tax until withdrawn. Some investments - like CDs, mutual funds and corporate bonds - are taxed regardless if the earnings are withdrawn.

A client can “time” the receipt of income and shift it into lower bracket years. This ability to decide when to be taxed allows the annuitant to compound the advantage of deferral.

**Annuitization**

The guarantees of safety, interest rates, and lifelong income give the purchaser peace of mind and psychological security.

All annuities, whether deferred or immediate, can provide a variety of income streams. Life settlement options offer income that cannot be outlived, something no other investment can offer. And if the funds are non-qualified, when annuitized, because of the exclusion ratio, the income stream is tax advantaged as well.

For younger people, annuitization can provide an income stream with the income tax on gains spread over the term of the settlement option.

For older people, non-qualified settlement options may help reduce the taxation of Social Security benefits by reducing the amount of income subject to taxation.

**Liquidity**

Today, at the very least, most annuities allow withdrawal of up to 10% of the account value yearly without incurring a surrender charge. Also, crisis waivers may allow a complete withdrawal without surrender charges under specific circumstances.

Because a 10% penalty tax applies when funds are withdrawn prior to age 59½, the liquidity advantage for younger people is much less advantageous than for those older than 59½.

- Earnings can be withdrawn instead of annuitizing, however, earnings are taxed when withdrawn.
- Access to at least a portion of funds provides a feeling of security in case of unforeseen financial needs arise.

**Probate Avoidance**

Although usually associated with people over 60, this advantage can apply to younger people as well. When a beneficiary has been named on the contract death benefits in an annuity do not become part of the probate estate. This allows the family access to the funds sooner and without costs of probate.
Protects and builds a person’s cash reserve

The insurer guarantees principal, interest, and the promise (if purchased) that the annuity can never be outlived. This makes the annuity particularly attractive to those who have retired and desire or require fixed monthly income and lifetime guaranteed.

- **Safety** of principle and earnings
- **Flexibility** through 1035 exchanges and ability to transfer funds from one subaccount to another in variable annuities.
- **Deferred Taxation** with the ability to choose when the funds will be taxed and even to spread it out over more than one generation through a stretch annuity.
- **Professional Asset Management** so investors don’t have to worry about day-to-day fluctuations in the market.
- **Enhanced Wealth Benefit** to take care of estate taxes or other estate needs.

**Surrender Charges**

Surrender charges allow current owners and prospective purchasers to know exactly what the cost of surrender will be. With most other investments, the owner has no way of knowing in advance what the charge for surrender is going to be.

Another advantage of surrender charges is that it protects the insurance company from adverse selection in the event economic conditions might cause many policyholders to withdraw their annuities at the same times which could be catastrophic for insurers. Surrender charges protect insurers which also protects contract owners so that their funds are safe.

**The Disadvantages of Annuities**

**Pre-59 ½ Distribution Penalty**

Annuities are designed to be long-term savings vehicles. With few exceptions, a deferred annuity has a penalty tax of 10% when funds are withdrawn prior to 59½. The penalty tax was created to discourage the use of annuities as short-term tax-sheltered investments. Using annuities for younger people may not be suitable. There are a few exceptions where the penalty tax does not apply.

A 10 percent penalty tax is generally imposed on withdrawals of accumulated interest prior to age 59½ or disability.

The 10% penalty tax does not apply for people over 59½ years old so it is not an issue for those over 60.

**Annuitization**

When a sum of money is annuitized, it is exchanged for an income stream. When a settlement option is selected:

- The policyholder relinquishes control of the deposit
- Once the payout starts, it cannot be stopped or changed to a different settlement option. A settlement option can't respond to future need for additional income or access to the principal.

**Tax Treatment of Gains**

Receipt of a lump sum at retirement could result in a significant tax burden.

Annuity gains are taxed as ordinary income when they are distributed. If a settlement option is elected, gains are generally spread over the duration of the settlement option. Annuity gains are not treated as capital gains. Under current tax laws, the top ordinary income tax rate is 35% while the top capital gains rate is 15%.

For younger people, this is not a significant an issue because the pre-59½ penalty tax is designed to discourage access for younger people anyway while an annuity is in a state of tax deferral. However, older people in high tax brackets should compare annuities with other income options that may be available.

A long-term cash flow stream of a fixed amount may not keep pace with inflation. With a few limited exceptions, an annuity contract held by a corporation or other entity that is not a natural person is not treated as an annuity contract for federal income tax purposes. This means that income on the contract each year is treated as current taxable ordinary income to the owner regardless of whether or not withdrawals are made.
Surrender Charges

If the client is forced to liquidate the investment in the early years of an annuity, surrender charges could prove expensive to compensate the insurer for the sales charges and other expenses.

If annuities are liquidated prior to their term, surrender charges usually apply. Some annuity contracts have excessively high surrender charges.

For older people who may need access sooner than younger people, surrender charges can be a huge disadvantage. Some products have surrender charges that last many years. Annuity contracts are available with surrender charges as short as three years. Agents should take the time to understand the client's needs prior to recommending an annuity. Selling an annuity with a surrender schedule that exceeds the client's need for the funds is unsuitable.

HOW ANNUITIES COMPARE TO OTHER INVESTMENTS

Certificate of Deposit

Like annuities, CDs are not tax free; the principal is protected and free of market risk; a charge applies to early withdrawals; and there is limited liquidity.

Unlike annuities, CDs are not tax deferred; there is no 10% tax penalty for pre 59½ distributions, there is no provision for tax-advantaged lifetime income; the CD does not avoid probate and it cannot help reduce the taxation of social security.

Money Markets

Like annuities, money market accounts are free from market risk and principal risk and neither investment is tax free.

Unlike annuities, however, there is no tax penalty for early distribution nor is there a fee; money market accounts have more liquidity than annuities but do not offer any provision for tax-advantaged lifetime income or avoid probate or help reduce tax on social security benefits.

Mutual Funds

Neither annuities nor mutual funds are tax-free investments.

Unlike annuities, mutual funds are not tax deferred, they do not provide protection from either market or principal risk; there is no fee for early withdrawal nor is there a tax penalty for pre 59½ distributions; mutual funds do provide more liquidity but they do not provide tax-advantaged lifetime income, avoid probate, or help to reduce taxation of social security benefits.

Stocks

Neither stocks nor annuities are tax-free.

Unlike annuities, stocks are not tax-deferred; stocks are subject to both market risk and principal risk; stocks allow more liquidity than annuities; there is no fee for early withdrawals nor is there any tax penalty; stocks do not avoid probate nor do they help reduce tax on social security benefits.

Bonds

Bonds have about the same amount of liquidity as annuities.

Unlike annuities, bonds are not free from market risk and, with the exception of government bonds; they are also subject to principal risk. Most bonds do not contain a charge for early withdrawal and are not subject to the 10% tax penalty for pre age 59½ withdrawals either. Bonds do not provide a tax-advantaged lifetime income nor do they avoid probate or help reduce taxation on social security benefits.

Commodities

Neither annuities nor commodities are tax-free investments. Both allow access to investments; however the commodities do not charge a fee for access nor a tax penalty for early withdrawal.

Unlike annuities, commodities do not provide a tax-advantaged lifetime income nor do they avoid probate or help reduce taxation of social security benefits.

Options

Both options and annuities allow access to funds and neither is a tax free investment.

Unlike annuities, options are not tax-deferred; they are subject to both market risk and principal risk;
options may charge a fee for early withdrawals but are not subject to the 10% tax penalty for pre age 59½ withdrawals. Options don't provide a tax advantaged lifetime income nor do they avoid probate or help to reduce tax on social security benefits.

**Limited Partnerships**

Neither limited partnerships nor annuities are tax-free investments.

Unlike annuities, limited partnerships are not tax deferred. Principal is free from market risk however they don't provide safety of principal. There is no access to the account value therefore there is no penalty tax on pre 59% withdrawals. There is no provision for tax-advantaged, lifetime income, they don't avoid probate nor do they reduce taxation of social security benefits.

**Promissory Notes**

Like annuities, promissory notes provide safety of principal. Neither promissory notes nor annuities are tax-free investments.

Unlike annuities, promissory notes are not tax deferred. Principal is not free from market risk. No access to the account value therefore there is no penalty tax on pre 59½ distributions. Promissory Notes do not provide tax-advantaged lifetime income; do not avoid probate and do not reduce taxation of social security benefits.

**Real Estate Investment Trusts (REIT)**

Like annuities, there is access to the account value. Neither Real Estate Investment Trusts nor annuities are tax free.

Unlike annuities, Real Estate Investment trusts are not tax deferred; principal is not free from market risk. REITs do not provide safety of principal nor do they charge for early withdrawal. There is no 10% penalty for pre age 59½ distributions. REITs do not provide tax-advantaged lifetime income; do not avoid probate nor do they reduce taxation of social security benefits.

**Viatical Settlements**

Like annuities, viatical settlements are free from market risk. Neither viatical settlements nor annuities are tax free.

Unlike annuities, viatical settlements are not tax deferred; do not provide safety of principal; do not allow access to the account value nor do they apply a penalty for pre age 59½ distributions, there is no tax-advantaged lifetime income. Viatical Settlements don't avoid probate nor do they reduce taxation of social security benefits.

**Savings**

Like annuities, savings are free from market risk and principal risk and neither investment is tax free.

Unlike annuities, however, there is no tax penalty for early distribution nor is there a fee; savings accounts have more liquidity than annuities but do not offer any provision for tax-advantaged lifetime income or avoid probate or help reduce tax on social security benefits.

The following table shows the average rates of return on several investments over a five-year period along with the range of renewal rates paid on flexible premium deferred annuities and single premium deferred annuities included in a survey covering the same period. The figures in the table show that fixed annuities can provide an accumulation rate that compares favorably with the returns available on other interest-bearing financial investments.
RATES OF RETURN: FIXED ANNUITIES AND OTHER INTEREST-BEARING FINANCIAL VEHICLES

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Money Market Funds</td>
<td>7.82</td>
<td>5.71</td>
<td>3.37</td>
<td>2.7</td>
<td>3.75</td>
</tr>
<tr>
<td>1-Year CDs</td>
<td>7.42</td>
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<td>3.12</td>
<td>3.94</td>
</tr>
<tr>
<td>1-Year Treasury Bills</td>
<td>7.35</td>
<td>5.52</td>
<td>3.71</td>
<td>3.29</td>
<td>5.02</td>
</tr>
<tr>
<td>10-Year Treasury Bonds</td>
<td>8.55</td>
<td>7.86</td>
<td>7.01</td>
<td>5.87</td>
<td>7.69</td>
</tr>
<tr>
<td>Corporate Bonds (AAA)</td>
<td>9.32</td>
<td>8.77</td>
<td>8.14</td>
<td>7.22</td>
<td>7.97</td>
</tr>
<tr>
<td>State/Local Govt Bonds (AAA)</td>
<td>6.96</td>
<td>6.56</td>
<td>6.09</td>
<td>5.38</td>
<td>5.77</td>
</tr>
<tr>
<td>Flexible Premium Deferred Annuities</td>
<td>6.75-9.25</td>
<td>6.00-9.25</td>
<td>5.05-8.80</td>
<td>4.70-9.00</td>
<td>4.00-9.00</td>
</tr>
<tr>
<td>Single Premium Deferred Annuities</td>
<td>7.10-9.65</td>
<td>5.75-9.00</td>
<td>3.65-8.75</td>
<td>3.00-8.60</td>
<td>3.00-8.00</td>
</tr>
</tbody>
</table>


ANNUITY INVESTING ADVANTAGES

There is no such thing as the perfect investment; however, an annuity provides more features than any other type of investment available, including:

- Safety
- Reserves
- Financial strength
- Ratings

Safety

By all investment standards the fixed-rate annuity investment is unequaled. In a fixed-rate annuity principal is guaranteed every single day. In addition, the contract owner is permitted to terminate the contract at any time—after a day, month or year.

In addition to the principal guarantee the interest rate also is guaranteed. The interest rate is guaranteed for a specific period of time, depending on the contract. Variable annuities are less safe because the investor decides the type of portfolio to enter into and the dollar amount that is going to be invested.

Reserves

Banks must, by law, set aside a certain amount into reserves for every dollar deposited into the bank. That amount can range from zero cents to ten cents on the dollar. When a fixed-rate annuity is purchased the insurance company must also, by law, set aside reserves.

The insurance company can use the reserves for settling withdrawals and redeeming annuities. Insurance company reserve money cannot be used to pay claims, overhead, bad debts or any other non-related annuity items.

Most states now require that the insurance company become part of the legal reserve pool. This pool protects the investor. Should an insurance company go out of business the reserve pool operates in a straightforward manner and the remaining insurance companies must reserve the liabilities and the obligations of the carrier that went out of business.
Financial Strength

There are more than 2,000 life insurance companies in the United States, and they collectively own, manage or control more assets than all the banks in the world combined. Collectively they own, manage or control more assets than all of the oil companies in the world combined. During the Depression the insurance companies, not the federal government, bailed out the banking industry.

Ratings

Annuities have a perfect track record, but consideration should be given to the insurance company providing the annuity. Some companies are safer than others.

The oldest rating company in the county is A.M. Best. They rate companies in the following manner:

- A+ superior rating
- A excellent rating
- A- excellent rating also
- B+ very good
- B good
- B good
- C+ fairly good
- C fair
- C- fair

Most investors prefer to stick with the A+ or A rated companies for fixed-rate annuities. For variable annuities, the rating of the insurance carrier is of little importance because the earnings are not tied to the solvency of the insurer.

Performance

Fixed-rate annuities offer a specific rate of return for a specified time and the rate is fully guaranteed for this period. The interest rate guaranteed depends on the annuity.

Professional Management

Professional management plays a very important role in the annuity field. The investment team or professional manager that oversees an annuity portfolio is in fact a specialist. These individuals are highly skilled and trained to focus on a certain segment of the marketplace. There are several independent sources that track the performance of fixed-rate and variable annuities. Some of these rating services are:

- Morningstar
- Lipper Analytical Services
- VARDS
- Standard & Poor’s

In addition, The Wall Street Journal and Barron’s publish articles from time to time related to annuities and annuity performance.

Avoidance of Probate

When an individual dies, the value of the following become part of the decedent’s estate:

- Assets
- Real Estate
- Bank Accounts
- Boats
- Stocks
- Vehicles
- Clothes

Probate fees are based on the gross value of the estate. This fee may be much higher than anticipated since the value of the estate will increase between now and the individual’s death, and the lawyer who probates the estate may ask the court for additional fees.

The value of an annuity will not be included when the gross estate is valued.

ALL ANNUITIES AVOID PROBATE.
THE SENIOR MARKET

With more and more Americans approaching retirement, the need for individuals to take charge of, and carefully plan for, their own retirement income has never been greater. Unfortunately many preretirees are woefully unprepared for what lies ahead.

In just a few years, the leading edge of the baby boomer generation of 77 million individuals will turn 60. But will they be able to meet the challenges of “retirement readiness”—a state of financial independence where decisions are made based on choice, not economic necessity? Will this generation, which is retiring earlier and living longer in an environment of diminishing Social Security and pension plan safety nets, be able to live comfortably in a retirement which may last 20 to 30 years or longer?

Today’s baby boomers can expect to live longer, healthier lives than any generation before them. While baby boomers will soon increase these figures even more, due to improvements in health care and lifestyle, the current older population itself is living longer.

According to the U.S. Bureau of the Census, by the year 2030, there will be twice the number of people age 65 and older as there were in 2000. This segment, which represented almost 13% of the population in 2000, is expected to grow to 20% of the population by 2030. Since 1900, the percentage of Americans age 65 and older has more than tripled (4.1% in 1900 to 12.4% in 2000), with the actual number growing eleven times (from 3.1 million to 35.0 million).

Today, a person reaching the age of 65 is likely to survive an additional 17.9 years.

For decades the median age at which people expected to retire is 62. However, a recent edition of The Harris Poll indicates that this expectation decreases with the current age of workers. Those age 25 to 29 expect to retire at age 60, for example; those 18 to 24, expect to retire at age 58. The fact that aging Americans are both retiring earlier and living longer, places additional strain on the need to prepare adequately for retirement. There will be a tremendous opportunity for insurance agents to sell annuity products to this growing older population.

An annuity can be appropriate as part of an overall financial plan for an older adult. There are many well-qualified and capable financial professionals who provide solid advice to their clients about annuities and other financial products. They provide complete information to clients, about advantages and disadvantages of the products they offer, in regard to the client’s individual financial position and objectives. However there are also many who prey on seniors using misinformation and scare tactics to sell annuities.

RISK AND THE SENIOR CLIENT

Agents and seniors should understand the delicate balance between risk and reward. Riskier investments have the potential for greater returns, while conservative investments typically generate lower returns. Conservative investments do not generate high enough returns but potentially higher-yielding investments subject seniors to principal risk. In the long-term failure to achieve growth while preserving principal increases the risk of outliving assets. All investments, however, subject seniors to some type of risk.

Interest Rate Risk

Interest Rate Risk applies to most fixed interest products where the prevailing interest rate is dependent on the market value of the underlying investment. Interest rate risk is a particular threat to stocks and fixed-income investments like bonds. Rising interest rates can make stocks less appealing and cause share prices to fall. Rising rates have an even more direct effect on existing bonds, nearly always causing them to decline in value.

Credit Risk

Credit risk also affects fixed rate investments, such as bonds. Essentially, a bond is like a loan and credit risk is the risk that the issuer of a bond will default on its obligation.

Business Risk

Business Risk is the risk that the investment's value will decline due to a decline in the underlying company's value. It is the possibility that the company issuing a security may not be able to meet its financial obligations.

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Market Risk

Market risk is the chance that financial markets in general may rise or fall in value. With a variable annuity, there is a risk of the underlying investments performing poorly. This risk is balanced by the potential of receiving a higher return than would be possible with a fixed return investment.

Inflation Risk

Inflation risk is one of the most important factors for long-term investors to consider especially when purchasing fixed annuities. If the return fails to keep pace or exceed the inflation rate, clients will lose purchasing power.

<table>
<thead>
<tr>
<th>Variable Subaccount</th>
<th>Conservative</th>
<th>Moderate</th>
<th>Aggressive</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>15%</td>
<td>30%</td>
<td>40%</td>
</tr>
<tr>
<td>Bonds</td>
<td>45%</td>
<td>40%</td>
<td>30%</td>
</tr>
<tr>
<td>International</td>
<td>5%</td>
<td>15%</td>
<td>25%</td>
</tr>
<tr>
<td>Money market</td>
<td>35%</td>
<td>15%</td>
<td>5%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

As the contract owner’s risk tolerance moves from low risk to high risk, the allocation of assets also moves from conservative—with an emphasis on fixed-income securities—to aggressive, with a correspondingly higher allocation to common stock and international subaccounts.

Risk of Outliving Assets

The biggest risk of all is the risk of outliving assets. This possibility has increased dramatically since people are living longer. Coupled with the trend for early retirement this means retirement savings must last even longer than in the past.

Balancing risk and return

Investors will not take on greater risks without the possibility of higher earnings. In general, the greater the risk, the higher the potential return; the lower the risk, the lower the expected return.

Although the terms “conservative,” “moderate” and “aggressive” change depending upon who is using them, asset allocations for these different contract owners could approximate those shown below:

As things in life change, such as income, age, or number of dependents, clients should reexamine their investments and rebalance them occasionally to design a strategy that is in line with their financial goals.
ANNUITY POLICY RISKS

The following scale compares the risk of eight types of investments to their possible gain.

![Risk/Unsafe and No Risk/Safe]

Agents should ask their clients which of these four categories best matches their investment attitude:

- **Conservative**: Feel very uncomfortable if the value of investments dropped, even in the short term. Willing to accept a lower long-term growth rate in order to reduce risk.
- **Moderately Conservative**: Willing to put some money into volatile investments in the hope of achieving substantial long-term growth, but keep most of it in more stable, low-risk investments.
- **Moderately Aggressive**: Want both stability and long-term growth, but with more emphasis on growth. Understand that this means putting money in investments that can go up or down in value at any time.
- **Aggressive**: Priority is significant long-term growth. Willing to accept a drop in investments’ value, even for several years, in the hope of achieving greater long-term growth.

RETIREMENT PLANNING

A comfortable retirement involves making certain that retirement assets, combined with Social Security benefits, will generate income sufficient to sustain the lifestyle seniors want.

Many of today’s pre-retirees expect to retire early and live long, healthy lives. At the same time, most underestimate the amount of money they will need in retirement, and many are not saving enough to continue their current lifestyle. According to the 2002 Survey of Prospective Retirees, 33% say they plan to live on just the interest and earnings from their investments during retirement; 29% plan to spend down their asset base. Only one in ten plans to increase assets each year.

Pre-retirees need to identify their retirement objectives early on so that investment portfolios can be tailored to meet future needs. Proactively managing investments is another important consideration.

Many financial experts today suggest that retirees will need between two-thirds and three-quarters of their pre-retirement income to maintain their current
standard of living in retirement. This is based on the premise that spending on such items as commuting, clothing, etc. will decline when one leaves the workforce. According to the 2002 Survey of Prospective Retirees, respondents feel they need to replace, on average, 60% of their income in retirement. Just over a third (35%) feel they need to replace 70% or more of their household's pre-retirement income to live comfortably in retirement.

Pre-retirees should also have a comprehensive financial plan that addresses other financial contingencies, such as long-term care. If a senior requires long-term care, the cost could wipe out a lifetime of savings. Since long-term care is not covered under most health plans, the only way to subsidize the cost may be by liquidating retirement savings. The cost of long-term care for one spouse may require the other spouse to make changes to living arrangements or return to work. It could also mean using the assets that seniors intended to pass on to the next generation.

After retirement, seniors need to make sure that funds accumulated during their working years can sustain their cost of living and retirement objectives over their remaining lifetime. This usually involves a shift in investment philosophy from emphasizing growth to a focus on safety and asset preservation.

A new study, conducted by Chicago-based Aon Consulting, finds that average spending declines very little in retirement. While some costs such as shelter decrease, others, such as healthcare, actually increase. The study also finds that post-retirement spending is on the rise, while saving by active workers as a percentage of income is declining. In recent years current retirees are spending at a rate that accelerates depletion due to recent market performance. Many retirees will have to reduce their living standards or they may run out of money altogether.

Retirement readiness presents a significant challenge to individuals and the federal government. It is clear that the future well-being of a large and growing segment of our population rests on finding a way to close the gap between the current inadequate level of retirement planning and the level that will be necessary for the tens of millions of individuals who will be retiring over the next decade.

The financial services and insurance industry has the necessary human, technological, and financial resources to help Americans enjoy their retirement. Agents can help by promoting and stimulating increased participation in both qualified and unqualified retirement plans.

Education, information and advice will be critical in helping individuals to both accumulate sufficient funds for retirement, and transform those savings into retirement income that will last as long as they live. That's definitely an area where annuities shine.

**FINANCIAL CONCERNS**

A generation ago, Social Security and pensions took care of most people's needs during retirement, which lasted an average of only twelve years. With people retiring earlier and living longer, many may spend almost as much time in retirement as they did in the work force. Traditionally the American retirement savings system has rested on three legs: Social Security, employer pensions, and personal savings. But with Social Security and conventional defined benefit pension plans predicted to play a considerably smaller role in providing retirement income in the future, it is clear that individuals must take a more active role in providing for their own retirement security.

**Social Security**

According to the Social Security Administration, Social Security currently protects 150 million workers with over 44 million people receiving retirement, survivor, and disability benefits.

Social Security was never intended to provide full retirement income for working Americans. Instead, it was designed to compliment other sources of retirement savings, such as pensions.

Social Security is funded by a combination of employee deductions and employer matching funds (or self-employment contributions) up to a maximum taxable earnings limit. In 2006, contributions are based on 6.20%, up to a limit of $94,200.

In general, individuals qualify for Social Security benefits by earning credits. In 2006, a credit is earned for each $970 of income up to a maximum of four credits per year. Most currently working adults will qualify for benefits with 40 credits (10 working years). Special rules apply to access benefits for survivors and to access disability benefits provided under Social Security.
The average monthly Social Security benefits paid to current beneficiaries in 2006 is $1,002 for all retired workers or $1,648 to an aged couple with both receiving benefits. The maximum Social Security Benefit for a worker retiring at full retirement age is capped at $2,053 per month (2006).

Social Security benefits are an important income source for retirement, but they are usually not enough. No one knows what the future of Social Security will be. In fact, the Chairman of the Federal Reserve Board, Alan Greenspan, recently suggested reducing Social Security benefits for future retirees.

Social Security today replaces about 40% of the average worker’s pre-retirement earnings. For two-thirds of the elderly, it is a major source of income; for one-third, it is virtually their only income. When Social Security started in 1935, a 65-year-old had an average additional life expectancy of just over 12 years; today that figure is over 17 years and rising. By 2030, there will be almost twice as many older Americans as there were in 2000. At the same time, the number of workers paying into the system per beneficiary will shrink from 3.3 today to an expected 2.0.

Many people think Social Security tax contributions are held in interest-bearing accounts earmarked for payments to future retirees. In reality, however, Social Security is a “pay-as-you-go” system, which means taxes paid by today’s workers fund benefits for today’s retirees. Social Security is now taking in more taxes than it pays out in benefits, with excess funds credited to the Social Security’s trust fund.

Based on the intermediate projection set out in the 2002 Annual Report of the OASDHI Board of Trustees, if no changes are made, the increase in benefit expenditure due to aging baby boomers will eliminate the surplus by 2017 and exhaust the trust fund’s accumulated reserves by 2041. Clearly, pre-retirees today will need to look beyond Social Security income if they are to live comfortably in retirement.

In 1998, 58 percent of all households with at least one member age 65 or older depended on Social Security for 50 percent or more of their total income, and more than one in four depended on it for 90 percent or more, according to the US Dept of Labor, Pension and Welfare Benefits Administration.

<table>
<thead>
<tr>
<th>The Social Security Full-Benefit Retirement Age, 2002-2025</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of Birth</td>
</tr>
<tr>
<td>-----------------</td>
</tr>
<tr>
<td>1937</td>
</tr>
<tr>
<td>1938</td>
</tr>
<tr>
<td>1939</td>
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<tr>
<td>1940</td>
</tr>
<tr>
<td>1941</td>
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<tr>
<td>1942</td>
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<tr>
<td>1943-1954</td>
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<tr>
<td>1955</td>
</tr>
<tr>
<td>1956</td>
</tr>
<tr>
<td>1957</td>
</tr>
<tr>
<td>1958</td>
</tr>
<tr>
<td>1959</td>
</tr>
<tr>
<td>1960 and later</td>
</tr>
</tbody>
</table>

Source: Social Security Online

For every client born after 1937 both the Social Security full-benefit retirement age and the financial penalty for taking benefits at age 62 scheduled to increase.

**SOCIAL SECURITY TAXATION**

A portion of Social Security benefits may be subject to income taxation, depending on the recipient’s tax filing status and level of “provisional income.” For most people, “provisional income” is adjusted gross income, plus tax exempt income, plus one-half of their Social Security benefits.
For a married couple, filing jointly, Social Security benefits become taxable if their provisional income exceeds $32,000. Between provisional income levels of $32,000 and $44,000, up to 50% of Social Security benefits are income taxable. Above the $44,000 level, 85% of Social Security benefits are income taxable. For married persons filing separately, the 85% tier applies from the first dollar of provisional income.

For a single person, the 50% tier of Social Security benefit taxation applies between provisional income levels of $25,000 and $34,000. The 85% tier of Social Security benefit taxation applies to provisional income levels above $34,000.

Many people resent the fact that their Social Security benefits can be subject to income tax. For these individuals, annuities provide a means of avoiding such taxation. Because annuity earnings and the excluded portion of annuity payments are not included in provisional income, shifting assets from taxable investments or tax-exempt bonds can sometimes lower an individual's or a couple's provisional income sufficiently that Social Security benefits will not be subject to income taxation.

**Retirement Plan Distributions**

Two primary sources for retirement plan distributions are employer-sponsored plans and individual retirement plans, such as IRAs.

ERISA (Employee Retirement Income Security Act) requires employers to provide information about plan features and funding on an annual basis to plan participants. It also establishes standards for resolving disputes, grievances, and legal actions.

Employers must file their plan documents with the Internal Revenue Service as well as an annual tax returns detailing plan contributions and assets help ensure continued compliance.

Along with Social Security, generations in the past have relied on company pensions known as defined benefit (DB) plans for retirement. With these plans, employers typically promised a lifetime stream of income to retirees based on their cumulative earnings, years of service, and age at retirement.

In 1978, the Revenue Act of 1978, was passed permitting certain types of defined contribution (DC) plans which allow employees to defer part of their pre-tax income until retirement. These plans typically establish contribution rates by employees and employers. Retirement benefits are based on the accumulated earnings of the funds. The most common example of a defined contribution plan is the 401(k). Many employer-sponsored profit sharing plans are also structured as defined contribution plans.

Over the past 25 years, these plans have radically changed the American pension plan system by shifting responsibility for the financing and investment of retirement benefits from employers to employees. Since their introduction, 401(k) plans have come to dominate the DC portion of the private pension system.

As participation in 401(k) plans has grown, coverage in DB plans has declined. Eighty million workers participated in private sector retirement plans in 2001. Approximately 70% of the total were in DC plans; only 30% were in DB plans.

In 1998, 47% of all contributions to pension plans were made by employees compared to only 11% in 1978. In real dollars, employer contributions to all types of pension plans were 18% lower in 1998 than in 1978, while employee contributions were 480% higher. The decrease in company pension plans greatly increases the burden on individuals to take charge of and carefully plan for their own retirement income needs. This is where annuities can help.

Another way of generating retirement income is from personally sponsored plans, such as IRAs, Roth IRAs or SEP plans.

**Retirement in the 21st Century**

If the experts are on target, retirement in the next century will scarcely resemble the conventional image of lazy days spent on cruise ships and golf courses. People might plan to open a business of their own. Or perhaps they'll return to school for that graduate degree they never had the chance to complete. Of course, they'll probably still find time to sit back and put their feet up.

At the turn of the 20th century, the average life expectancy was 47 years. Today, the average American can look forward to about 77 years of life. By 2040, individuals who reach age 65 are projected to live until age 81 to 85 for men and age 84 to 88 for women, according to the National Center for Health Statistics.
This is primarily a result of improved health care, both in the form of preventative medicine and during the later years of life. Medical advances, ranging from beta blockers that control hypertension to hip replacements, allow older Americans to remain active. Healthier lifestyles are also a contributing factor.

The result is a new way of thinking about age. In her best-selling book, *New Passages*, Gail Sheehy argues that the "mid-life passage" generally thought to take place at age 40 now occurs a decade later. The period between ages 45 and 65 is no longer middle and old age, according to Sheehy, but a "second adulthood." Psychologist Ken Dychtwald, chief executive officer of Age Wave Inc., a California-based consulting firm, also sees new lines being drawn. Using his model, ages 25 to 40 represent young adulthood, while ages 40 to 60 comprise a new stage known as "middlescence." Next comes late adulthood (60 to 80), followed by old age (80 to 100), and very old age (100+).

But perhaps more important than the categories is the effect that longer, healthier lives may have on the traditional life cycle of education, work, and retirement. It will be replaced by a less linear cycle, according to Dychtwald, who predicts short-term retirements, followed by any combination of career shifts, part- or flex-time work, entrepreneurial endeavors, and continuing education peppered with occasional "mini-retirements."

Today's older American doesn't hesitate to change jobs — or careers — in the pursuit of keeping life interesting. This trend should accelerate. Currently, about 30% of those aged 65 years or older are in the labor force and that percentage is expected to increase to 37% by 2015.* "Source: Bureau of Labor Statistics, 2000.

So what does this redefined retirement mean to you and your client? There is no one answer. In the coming decades, "retirement" will mean something different to each of us. Regardless of their decision, you'll need to help clients design a financial plan suited to their specific vision of the future.

Ignorance about pensions is widespread, even among people in the last decade before what we commonly think of as retirement age. Using the *Health and Retirement Study*, researchers Gustman and Steinhmeir compared what people say about their pension plans with what their employer said about the same plan. Here is what they found:

- Almost half of pension participants for whom employer- and self-reported pension information could be matched were wrong about the type of plan (defined benefit versus defined contribution) under which they were covered.
- Among respondents with a defined benefit plan, only 43 percent knew—withins a year—the age at which they would be eligible for early retirement benefits, and 80 percent either thought (incorrectly) they were ineligible to retire early or did not know how much their benefits would be reduced for doing so (typically four to five percent).
- Only 40 percent of participants could report, even roughly, the accumulated dollar value of their pension plan assets.

It is not clear how the client can make informed decisions about when to retire or how much to save—in or out of the pension plan—without at least some of this information. And the financial planner needs to find out this information from the client's plan documents, not directly from the client, to be sure to give the client valid and applicable advice.

**HOW THE ANNUITY HELPS FULFILL CONSUMER'S RETIREMENT OBJECTIVES**

Annuities have become a popular choice among agents and consumers alike. The IRS gives annuities preferred tax treatment. Through a variety of designs - fixed, equity-indexed and variable - annuities can accommodate many long-term objectives including the ability to create a reliable and systematic income stream for the owner.

The two primary tax advantages of annuities are: that earnings grow on a tax-deferred basis and payouts receive favorable income tax treatment. To see how powerful these benefits are in comparison with other income alternatives, here is an example.

Mary is 60 years old. Her income puts her in the 27% tax bracket; she plans to retire in five years. The $100,000 she has saved towards her retirement is currently invested in a CD earning 8%. A fixed annuity is also paying 8%.

In her 27% tax bracket, the after-tax rate of return on a CD paying 8% is 5.84%. In five years, Mary $100,000 CD will be worth $132,815 on an after-tax
basis. But if she bought a $104,000 single premium deferred annuity paying 8%, the annuity would be worth $146,933 in five years. Even if she surrendered her annuity at that point and paid tax at a rate of 31% on her gain, she would have $132,384.

However, she wouldn't have to surrender her annuity at that point. She could convert the entire $146,933 into a single life annuity that would guarantee her an income, according to the insurer’s annuity tables, of $938 for life. Because of the exclusion ratio, she would pay tax on only $522 of that amount. At a tax rate of 15%, her annuity income would be reduced by only $78 per payment, leaving her spendable income of $860.

The interest on her 8% CD would provide her with only $882 of income per month, and she would pay tax on that entire amount. At a tax rate of 15%, her income from a CD would be reduced by $132 per month, leaving her with only $750 of spendable income per month. An annuity would provide her with $110 more per month in spendable, after-tax income, If Mary kept her CD, she might be forced to begin spending her principal to make ends meet, but then she would see her interest earnings fall increasingly each year. If Mary didn't want to convert her annuity fund to a single life annuity, could still avoid having to pay tax on her entire gain by initiating a systematic withdrawal plan.

**Investing Retirement Assets**

When investing retirement assets, there are several considerations that seniors should take into account.

- **Diversification** - A diverse portfolio helps reduce risk in general and assure that gains will balance losses.
- **Preservation of Capital** - The assets used to generate retirement income should be focused on preserving capital.
- **Peace Of Mind** - Seniors can achieve peace of mind by using asset allocation to allocate money across different asset classes, like stocks, bonds, cash and real estate.
- **Fighting Inflation** - Since goods and services are likely to cost more in the future than they do today it is important for investments to keep up with inflation.

According to a Report on Vanguard Defined Contribution Plans: “How America Saves 2002,”, less than half of all American workers were covered by employer retirement plans at the end of 2001. But even those that do participate in retirement plans, according to a recent Washington Post article, have saved very little. Of all the workers with 401(k) plans in 2000, 44% had balances of less than $10,000; 14% had only $10,000-$20,000.

According to the 2002 Employee Benefit Research Institute (EBRI) Retirement Confidence Survey, the amounts accumulated for retirement by workers as a whole are generally small. Almost half (46%) have saved less than $50,000; 15% say they have saved nothing. Fewer than 2 in 10 (17%) say they have $100,000 or more saved for retirement. While the amount accumulated generally increases with age, less than one-quarter (23%) of those ages 40-59 report having saved $100,000 or more. The majority of workers expect to spend at least 20 years in retirement, so even with $100,000 saved, they would have only $5,000 per year to spend.

**Retirement Planning With Annuities**

The annuity, whether fixed, variable or a combination is an excellent funding method for the full range of retirement programs. Annuities are well-suited to the long-term saving and income-creation needs associated with retirement planning. For virtually anyone, annuities can fulfill an important role in retirement planning.

For many people, retirement won't be just a 10- or 15-year period. People are living longer. Not only are more people living to retirement age; people are living longer after they’ve retired. According to current annuity mortality tables, three out of five individuals age 65 today can be expected to live to age 85. Two out of five will live to age 90. One out of five will live another 30 years to age 95. That's a wonderful thing, unless of course, their money runs out. Accumulating an adequate retirement fund and making it last for the remainder of their nonworking life calls for careful planning and wise choices about financial vehicles.

While an individual is still working, concern about retirement focuses on accumulating an adequate retirement fund. Worries about inflation, job security in the wake of corporate downsizing, and uncertainty about the future of Social Security are giving a sense of urgency to individuals’ concern about having adequate savings for retirement. According to a survey conducted by Yankelovich Partners, almost 60% of married couples between the ages of 40 and 65 with household income
above $50,000 said their greatest retirement fear is not having enough money to live comfortably.

Annuities offer a number of benefits as retirement savings vehicles. One of their most important benefits is tax-deferral. Tax-deferred funds accumulate to greater amounts over the years compared to funds on which tax must be paid each year. This is the result of what is sometimes referred to as "triple compounding." That is, interest is earned on:

1. principal,
2. interest, and
3. dollars that would otherwise have been paid in taxes.

Although dollars on which no tax has yet been paid will eventually be taxed when they come out of the contract, deferring taxation increases the effect of interest compounding during the period of deferral. Because of tax-deferral, annuities have a long-term growth advantage over vehicles whose earnings are taxable each year, such as bank accounts and CDs.

ACLI’s "Profile of Immediate Annuity Owners" (2003) reports that 64 percent of owners have annual household incomes of less than $50,000 and 63 percent have no pension income. Middle-income consumers are creating their own personal pensions with annuities.

**USING THE ANNUITY TO ACCUMULATE RETIREMENT FUNDS**

Annuities can be an important part of an investor's portfolio; however, retirement planning should be based on a well-rounded investment approach.

**USING THE VARIABLE ANNUITY IN RETIREMENT PLANNING**

For investors willing to accept market risk in exchange for greater potential returns, variable annuities may be a better choice than other equity-based investments. Today, most variable annuities feature asset allocation, a process through which an investor allocates money across different asset classes, like stocks, bonds, cash and real estate. The process reflects an investor's personal attitudes about investing by addressing a variety of factors. By changing the asset allocation mix, investors can re-act to different market trends.

Equity-based investments are subject to risk. But variable annuities containing a guaranteed monthly income benefit rider can protect against the risk of market losses.

**USING THE EQUITY-INDEXED ANNUITY IN RETIREMENT PLANNING**

Investors who are unwilling to accept the potential risks associated with stocks, mutual funds and variable annuities, may like equity-indexed annuities with earnings that are linked to positive changes in a major market index. Unlike the variable annuity, the investor in an equity indexed annuity does not assume investment risk. Equity-indexed annuities even include a minimum guaranteed interest rate in case the index fails to perform over the long-term. There is no risk to principal provided the annuity is held until the end of the surrender period.

Equity-indexed annuities are unique because they prevent index earnings from being lost once they are credited. To understand the significance of this feature is extremely important in retirement planning. With equity-indexed annuities, once gain is credited, it cannot be lost, even if the index loses value in subsequent years. This helps retirement income keep up with inflation without the vulnerability of the principal & past earnings to loss.

**USING FIXED ANNUITIES IN RETIREMENT PLANNING**

Provided fixed annuities are not liquidated during the surrender period, they provide safety of principal and guaranteed growth. Seniors more commonly purchase fixed and equity-indexed annuities than variable annuities. Seniors usually cannot afford the risks that come with equity-based investments especially since they may depend on the funds at some time in the future for their income.

Municipal bonds or corporate bonds are often included as part of an individual's investment portfolio. However, in periods of rising interest rates, principal may be susceptible to loss. Annuities can be a viable alternative to bonds.
INSURANCE CONCERNS

Health Insurance

In 1965, the Old Age Survivors Disability and Health Insurance Act (OADHI) created Medicare, a federal program of health insurance coverage for Americans 65 and older. Medicare is funded by payroll taxes with the current rate at 1.45% of all earnings. Like Social Security taxes, Medicare contributions are deducted from the paychecks of all working Americans and the employer matches the contribution levels. Unlike Social Security, there is no income limitation on the deduction.

Part A of Medicare covers inpatient care in hospitals, critical access hospitals, and skilled nursing facilities. It also covers hospice care and some home health care under certain conditions. Most older Americans qualify for Medicare Part A services once they turn age 65 with no premium.

Part B of Medicare covers doctors' services and outpatient hospital care. It also covers certain physical and occupational therapy, durable equipment and some home health care. Part B is subject to an additional premium of $88.50 per month in 2006.

To supplement the gaps between Medicare and complete coverage, private insurers introduced health plans called Medicare supplements, or Medigap policies. There are 10 approved Medigap policies, named "A" though "J", each providing a standard set of benefits and offered by a variety of private insurers. Not all insurers offer all 10 plans.

In 2003, major reform of Medicare was passed with the Medicare Modernization Act. This legislation incorporates a drug discount card program provided through private insurers and was implemented in June 2004 and discontinued in December 2005. In addition, a major drug coverage program was passed and was introduced in 2006. The drug coverage incorporates features and limits similar to other Parts of Medicare such as monthly premiums, deductibles, and co-payments.

The Balanced Budget Act of 1997 made several cuts in the Medicare Programs, especially in regard to home health care. The BBA also created managed care plans, referred to as Medicare+Choice options. These plans generally include most of the features of Medicare Parts A & B and Medicare supplement plans, usually along with other additional benefits. Deductibles and co-payments are reduced or eliminated for participants.

Employer-sponsored health plans for retirees have been cut significantly in recent years due to skyrocketing health care costs and insurance premiums.

Long-Term Care

Long-term care provides medical, supportive and personal services for people who are chronically ill. Long-term care provides help with performing activities of daily living, such as bathing, dressing, toileting, eating, transferring, and continence, or protective supervision for those with cognitive impairments.

Due to longer lifespans, rising costs and changes in family demography, paying and providing for long-term care has become an important issue. If not properly addressed, Long-term care could devastate retirement savings. According to statistics from the California Department of Health Services:

- The average cost of nursing home care in 2006 is $190 per day, or approximately $69,350 per year.
- The risk of needing long-term care is 4 in 10 for people age 65 and older - that's a 40% chance. For people 85 and over the risk goes up to 60%.
- The average length of a nursing home confinement lasts 2.6 years but more than twice as many people are receiving care in their homes.

LTC under retirement health plans or other sources are extremely limited, by the type of care they cover, the length of time for which they cover care, and the amount of the benefits payable.

Medicare provides very little coverage for long-term care services. While it covers some short-term nursing care which is recuperative in nature. Medicare was never designed to address the long-term needs for personal and custodial care and supervision.

Assistance for long-term care services is available from Medicaid, a welfare program which is jointly funded by state and federal funds. It will cover certain long-term care services for individuals with very limited assets and income. However, Medicaid provides no payment for assisted living and very little for home care.
Private insurance is available to cover long-term care services in a variety of different service settings. Under the Health Insurance Portability and Accountability Act of 1996 (HIPAA), benefits of a tax-qualified insurance contract will not be taxed and premiums may be deductible. HIPAA standardized benefit triggers, added consumer-marketing protections, and incorporated provisions that require services to be long-term in nature, or certified to be necessary for a period of ninety days or longer.

The most popular long-term care insurance plans offer coverage up to a daily or monthly maximum benefit in a variety of service settings, including nursing facilities assisted living facilities (residential care facilities) and home and community care. Many consumers prefer comprehensive policies that offer a pool of benefit dollars that can be used for care across the entire long-term care continuum. Benefits may be subject to a lifetime dollar maximum, as well as a maximum per day, week or month for services. Lifetime (unlimited) benefits may also be available.

Inflation coverage is an important element for insuring that benefit levels keep pace with rising costs. The most common inflation feature is an automatic 5% compounded annual escalator. Premium features include spousal or partner discounts, and the option of accelerated payment features.

Insurance agents need to address the potential financial devastation that can result from long-term care needs with their clients. Before clients tie-up money in an annuity with a surrender charge they must be sure they will not need that money for long-term care expenses. Long-term care riders can sometimes be used to this exposure, particularly if the senior does not qualify to purchase traditional LTC insurance.

### Risk Of Needing Long-Term Care

![Nursing Home Care](image1)

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![Home Health Care](image2)

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<tr>
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<tr>
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### Estate Planning

Estate planning involves the orderly process of transferring wealth from one generation to another with as little loss due to taxes, probate and other costs as possible so that the maximum amount is passed on per the deceased's wishes. A good estate plan must be reviewed and updated as life situations change.

If a premature death should occur, the accumulating funds within the annuity may be transferred to named beneficiaries, avoiding the expense, delay, frustration and publicity of the probate process. Like most assets, the annuity is part of the taxable estate, but since they pass to beneficiaries without probate, the money is available to them almost immediately after death.

An important part of estate and financial planning is dealing with disability or incapacity. *Durable powers of attorney, medical powers of attorney, living wills and health care directives* should be drawn-up by competent legal professionals so that the senior’s wishes can be carried out even if they are mentally or physically unable to do so themselves.

Another important element of estate planning is to address whether the estate will be subject to estate taxation. If it is anticipated that the estate will be taxable, it may be possible to establish trusts or charitable giving arrangements that will minimize the taxes paid on the estate, often through the use of annuities. Life Insurance riders can also help by providing funds to pay estate taxes.
SUITABILITY

“Suitability” is defined as a sale or recommendation that “meets the needs and goals of a person based upon reasonable inquiry concerning the person’s insurance objectives, financial situation, age and other relevant information”.

Annuities are available in a variety of shapes and sizes. Immediate, deferred, fixed, indexed, variable, single-premium, flexible premium. By matching a client's needs and resources with these variables, an annuity can be designed to fit almost any situation.

To meet the criterion of suitability, the recommendation of a given annuity must be appropriate for any particular client in light of his or her financial objectives, circumstances, and needs.

Whether an annuity is suitable for your client depends on a variety of factors, which are often interconnected. As an agent, solving the suitability equation is the result of gathering critical information and knowledge.

- The agent should have a solid foundation of the issues surrounding annuities in general.
- The agent should understand the provisions, features, and limitations of the annuity they intend to sell.
- The agent should take time to understand the client's unique circumstances including, but not limited to, financial status, tax status and investment objectives.

In general, any annuity purchaser should have a need and desire for long term accumulation and should be able to afford the annuity premium. In addition, the annuity owner should generally not expect to need to withdraw funds from the annuity in the near future. For variable annuities, the purchaser should also have a need and desire for the growth potential offered by securities, and a willingness to accept the risk that accompanies that potential for growth.

One of the agent's most important responsibilities is to make sure a potential buyer thoroughly understands the features, benefits and drawbacks of a financial product before he or she commits to its purchase. Financial professionals who sell variable annuities have a duty to advise clients as to whether the product they are trying to sell is suitable to their particular investment needs. For the variable annuity sale, the agent should ensure that the client understands the following:

- Risk to principal
- Fluctuating investment returns
- No guaranteed growth
- Premium payment options or requirements
- Subaccount investment options and the risk they entail asset allocation and diversification reallocation options tax deferral surrender charges (how long they last and how much they are) free withdrawal provisions, if any IRS penalties for early withdrawals tax treatment of withdrawals tax treatment of annuitization death benefit guarantee annuitization options
- Fees and charges, including the mortality and expense charge

THE NAIC'S SUITABILITY MODEL

The concern over annuity suitability is growing, not just in California but nationwide. The NAIC believes that the states should apply the suitability standards of the securities industry to fixed and registered insurance products, and that both the producer and the insurer should play a role in determining suitability.

In connection with their increased scrutiny of annuity sales, the National Association of Insurance Commissioners (NAIC) a national association of state insurance regulators, have developed a model regulation that will govern required disclosures in the sale of annuities.

The model creates standards for both agents and insurers to be sure that the insurance needs and financial objectives of senior consumers are appropriately addressed whenever the sale of an annuity is recommended to a senior (65 years or older).

Recommendations for Required Disclosures in Annuity Sales

1. Identification of the product as an annuity
2. Identification of the issuing insurer
3. Specific description of when surrender charges apply
4. Explanation of how the current interest rate will be credited, the period during which the
initial rate applies, the guaranteed minimum rate, and how future interest rates will apply
5. Statement regarding availability of a death benefit
6. Description of the effect of current tax law on annuity accumulations and withdrawals
7. Statement of any other policy charges and fees

Under the NAIC Senior Protection in Annuity Transactions Model Act and Model Regulation, a "senior" consumer was defined as a person sixty-five years of age or older.

A number of insurers and trade organizations filed comments and participated in several conferences of the NAIC Life and Annuity (A) Committee which resulted in significant changes to the Model Regulation. On September 14, the Model Regulation was adopted by the full NAIC. It imposes a suitability standard on insurance producers, and insurers that is patterned after NASD Conduct Rule 2310, requiring that agents have reasonable grounds for believing that the recommendation is suitable on the basis of the facts disclosed by the senior consumer as to his or her investments and other insurance products, and as to his or her financial situation and needs. Insurers are required to either establish and maintain a system to supervise recommendations that is reasonably designed to achieve compliance with the regulation, or contract with a third party, including a general agent or independent agency, to maintain such supervisions with respect to insurance providers under contract with or employed by the third party. Finally, the Model Regulation authorizes the insurance commissioner of a state to order an insurer, insurance producer and/or general or independent agency to take reasonably appropriate corrective action for any senior consumer harmed by the insurer's or insurance producer's violation.

Criteria for Assessing Annuity Suitability with Seniors

Purchasing an annuity should entail looking at a senior's total financial picture, both today and into the future as well. The NAIC has identified four criteria which should be evaluated prior to making a recommendation.

- Criteria 1. The senior's financial status;
- Criteria 2. The senior's tax status;
- Criteria 3. The senior's investment objectives; and
- Criteria 4. Other information which may be a consideration regarding the purchase.

CONSIDERING FINANCIAL STATUS

Purchasing an annuity usually means making a long-term commitment; one that carries costs (i.e. surrender charges) if the senior is forced to prematurely surrender the contract for such reasons as a change in financial status. That is why it is so important to take time early on to understand the senior's current financial status and how that may be likely to change during the term of an annuity. It is important to evaluate these considerations from a present and future perspective.

Income

Consider the senior's income needs. Many seniors live on a strict budget and rely on multiple sources of income to sustain lifestyle. Agents should verify that seniors have additional resources to supplement additional income needs in the short-term.

Liquid assets

Are the senior's liquid assets sufficient, and does the amount they intend to invest represent too great a portion of the senior's total liquid assets? Most financial experts agree that seniors should have liquid assets equal to of at least 6 months of living expense.

Is Comprehensive LTC Insurance in place?

Consider the senior's other financial needs. Does the senior have a complete financial plan, including long-term care insurance for example? Are there other expected short-term financial contingencies - like owing income tax on the sale of a home - that might take priority over the purchase of an annuity?

The consumer's tax status

Annuities provide special tax advantages. Earnings receive the benefit of tax-deferral while they remain in the annuity. And where non-qualified annuities are concerned, the income stream from a settlement option is also tax-advantaged.

The annuity's distributed earnings and interest will receive ordinary tax treatment
While annuity funds accumulate tax deferred within the contract, on withdrawal or distribution their earnings are subject to tax as ordinary income, not capital gains. The buyer’s tax bracket should be considered, as well as that of the beneficiary who would be responsible for the income tax due on the earnings upon the death of the owner or annuitant. Agents should also consider the senior’s tax status before recommending an annuity.

**The Senior’s Income Tax Bracket**

The senior’s tax bracket is an important consideration to evaluate where withdrawals are anticipated. Many seniors have relatively low income tax brackets. Since gains in non-qualified annuities are withdrawn first, earnings are subject to income tax. Agents need to exercise caution to ensure that structuring withdrawals will not send the senior into a higher tax bracket, or worse yet, trigger the taxation of Social Security benefits.

If non-settlement withdrawals are anticipated and the senior is in a high tax bracket, tax-free investments may be more suitable than tax-deferred annuities because they might ultimately leave the senior with more usable dollars.

**The Income Tax Bracket of Beneficiaries**

A beneficiary pays ordinary income tax on annuity gains. If the beneficiary is a high-income earner, gains (and pre-tax contributions) are taxed at the beneficiary’s income tax rate. If wealth transfer is the sole objective in purchasing an annuity, life insurance is more suitable.

**The Tax Consequences of Exchange**

In some cases, a senior may wish to liquidate or exchange another investment to purchase an annuity. However, an exchange or liquidation may carry tax consequences and other costs that negate the benefits of the annuity.

**The 10% Penalty Tax**

Annuities were not intended to be short-term tax shelters. A 10% tax applies when withdrawals are made prior to the age of 59½. When working with working-aged adults, annuities may not be suitable if the client anticipates access prior to 59½. While seniors are not affected by the 10% penalty tax, their beneficiaries may be.

**The consumer’s investment objectives**

Due to design innovations, annuities can accommodate a broad range of investment objectives. Still, the benefits of an annuity may not always be compatible with the senior’s financial objectives.

**The Senior’s Risk Tolerance And Return Expectations**

With a choice of fixed, equity-indexed and variable annuities, agents can usually help satisfy the senior’s risk tolerance and reward expectations. Knowing which type of annuity is most suitable requires a solid understanding of the products themselves.

As agents, it is important to help consumers make reasoned and personal decisions when it comes to evaluating which type of annuity is most suitable. Riskier investments usually translate to higher potential for return while conservative investments offer lower reward potential. The same can be said for fixed, equity-indexed and variable annuities.

Seniors, in particular, tend to be especially sensitive to this issue since many of them may rely on their annuity for income at some point in the future.

**The Senior’s Investment Horizon**

It is important that the surrender period of the proposed annuity coincides with the date the senior wants to access or annuitize the funds. Many annuities on the market today have surrender periods of 10 years or more. If the senior anticipates a five-year horizon, a 10-year surrender period may not be suitable due to the surrender charge.

**The Senior’s Liquidity Needs**

Although most annuities contain some liquidity provisions they are not a major source of liquidity. If the senior needs more than the contract allows, a costly surrender charge applies. In this event, another investment vehicle might be more suitable than an annuity.
The Investment Frequency

If the client wants to make systematic deposits into an annuity, the contract must be structured to accept additional deposits once it has been opened. A flexible premium deferred annuity vs. a single premium deferred annuity would be advisable under these circumstances.

Other information to be used or considered relevant

Making suitable recommendations requires an educated agent to use their comprehensive product knowledge to match solutions with the needs of their client. The State's new training requirements provide agents with the fundamental knowledge required to help make suitable recommendations. Agents must continually seek additional training in order to stay on top of the many changes in the annuity marketplace.

Buyer's guides are available from the NAIC to help consumers make informed decisions. Many states also have a buyers guide on their web sites.

The Need for Full Contract Disclosure

Annuity products can be complex. The more complicated the product, the greater the chance that a client may not understand it fully.

Agents owe a prospective client a duty of honesty, good faith and fair dealing. The Department Of Insurance wants agents to assist consumers to make informed buying decisions.

To accomplish this, agents have an implied responsibility to provide full disclosure including advantages and disadvantages for the clients situation. Suitability demands that producers recommend only those products with which they are familiar and that they can explain easily. In addition, they should be able to discuss the financial strength and track record of the issuing insurers.

REQUIRED DISCLOSURES

The primary determinant of full disclosure is whether the client has been provided, in an understandable manner, with all of the facts that are material to his or her purchase decision. Regulators say that the three main areas of deficiency in regard to annuity sales disclosure involve the following:

1. Interest rates
2. Surrender charges
3. Tax implications

Interest Rates

An annuity is a long-term contract. Clients must understand that interest rates and market conditions change.

Surrender Charges

Clients must understand the period of time and the conditions under which surrender charges may be assessed as well as any exceptions such as “Free” withdrawals.

Tax Implications

Clients must understand that annuities earn interest on a tax deferred, not a tax-free basis. Taxes are due on annuity accumulations when they are paid out of the contract. Clients must also be aware of the 10% penalty tax to which withdrawals from the contract may be subject if they are made prior to age 59½, unless certain exceptions apply.

PROSPECTUS

Variable annuities are considered securities and must be registered with the SEC. The SEC requires that all variable annuity sales materials include a prospectus, which contains all of the relevant information regarding the contract. The prospectus is a valuable tool which reveals any hidden charges not defined clearly in the supporting marketing materials. The prospectus outlines all costs and benefits, defines terms, discusses the issuer and gives the potential contract owner information. When used properly the prospectus can be an effective sales tool.

Since variable annuities are securities, a prospectus must be delivered to a prospect before, or at the time of, sale. The prospectus provides the client with essential information regarding the variable annuity. Information contained in a prospectus includes:

- Charges and fees
- Listing of subaccounts
- Description of what investments can be made in each subaccount
- Description of the subaccount objective
- Additional benefits
• How to determine the death benefit

**Profile**

Recently the SEC has allowed companies to issue brief prospectus "profiles" along with their prospectuses which provide a summary of the variable annuity's main features in plain English and in a standardized format. To create and use a profile, companies must conform to a set of guidelines created by the National Association for Variable Annuities (NAVA), which was instrumental in developing the profile. The Guidelines for the Variable Annuity Profile describe certain disclosure items that must be included in the profile. The profile describes the annuity contract's terms, payout options, investment options, expenses, tax treatment, performance characteristics, death benefits, purchase terms, and withdrawal provisions. The order in which these items must appear is specified in the guidelines, and the profile's content is limited to the items in the guidelines. The profile is not a substitute for a prospectus, but must be provided in conjunction with it. The profile may be bound together with the prospectus or given to the client along with the prospectus as a separate item.

**LIVING TRUST MILLS**

One example of a trust mill is the Alliance for Mature Americans. In 1997, the People of the State of California sought civil penalties, restitution, and injunctive relief against several insurers and licensed agents. The People alleged that the Alliance for Mature Americans provided living trusts to seniors and then used aggressive sales tactics to liquidate assets into annuities. In some cases, there were even allegations that some clients suffered from Parkinson's or Alzheimer's disease. Since 1991, the Alliance For Mature Americans sold some 10,000 trust packages with an estimated worth of $200 million.

In 1999, the case of the People vs. Fremont Life Insurance Company went to trial in Los Angeles Superior Court. The determinations, as quoted from Attachment II, Commissioner Low's letter, were as follows:

- "The insurer was involved in and responsible for the unauthorized practice of law by its agents in marketing estate plans."  
  **Commentary - Section 6125 of Business and Professions Code clearly states, "No person shall practice law in California unless the person is an active member of the State Bar." Agents do not have the authority to draft, deliver, or interpret legal documents such as wills or trusts.

- "The insurer was engaged in an unfair, fraudulent and deceptive business practice in the marketing of its annuities where, pursuant to training practices known to the insurer, its agents:
  1. Misrepresented that they were advisors on matters of estate planning through the use of inter vivos trusts, rather than salespersons who had the ultimate goal of selling annuity policies to senior citizens.
  2. Misrepresented that the agency was an organization of senior citizens or an organization which functioned on behalf of senior citizens, rather than an insurance sales organization.
  3. The insurer was responsible for the acts of its agents, not only under the theory of agency, but that of ratification for accepting the substantial benefits of the unlawful acts of its salespersons."

The outcome...the court ruled in favor of the People, ordering $2.5 million in injunctive relief, restitution to policyholders, and civil penalties. The Alliance for Mature Americans is out of business.

Quite often a living trust is a more efficient and even occasionally a less costly alternative to a Will. Unfortunately, scam artists have gotten into the game and are using living trusts to "fleece the trusting." According to Bill Lockyer, California's Attorney General, some 10,000 people have been swindled in this way. One company, the Alliance for Mature Americans, took millions from the elderly.

Those "selling" living trusts for the Alliance for Mature Americans, had clients reveal everything about their finances in a questionnaire called a "smoke sheet" because it was designed to smoke out funds in retirement plans, savings accounts and whatever. They were taught how to gather this confidential information and the Alliance, in turn, promised to draw up instructions to banks, brokerage houses, and financial institutions.

Up to this point, the Alliance is doing what would be expected by someone establishing a living trust. Part of the process is making sure all assets are
identified, accounts and automobiles are re-titled, property is deeded to the Trust, life insurance and IRA beneficiaries or ownership are revised, and all required paperwork is completed.

Once salesmen obtained this financial information, their goal was to convince the elderly their savings were not safe and to move all of their money to an annuity.

The California Attorney General’s office closed down the Alliance for Mature Americans and finally won a $200 million settlement. George Hoffman, a former Alliance salesman, testified at the trial that the company and his fellow salesmen "see taking money from seniors as a lot easier than doing something else, like robbing banks."

The best protection against scam artists and fly-by-night trust salesmen is to do business with an attorney who is knowledgeable in estate planning, one whose goal is to provide clients with the estate plan they need, not a generic one he is "selling," and who will be there to make sure the trust is properly funded and administered before and after death.

The Court of Appeal has upheld an order requiring an insurance company to pay more than $200 million in penalties and restitution for unfair business practices in the marketing of annuities to seniors. The Dec. 18 ruling by the court’s Division Two upholds the judgment against Fremont Life Insurance Co. rendered by Los Angeles Superior Court Judge Ronald Sohigian.

In 1996, (then) Attorney General Dan Lungren and the State Bar sued the Orange County-based Alliance for Mature Americans, as well as Fremont and other insurers, alleging the alliance provided living trusts to seniors who requested them, then used hard sales tactics to convince them to reinvest their assets into annuities.

The State Bar’s involvement was a result of claims that representatives of the Alliance for Mature Americans, the organization that did the actual marketing, were engaged in the unauthorized practice of law.

The complaint charged the average Alliance client was 73 years old, and that some suffered from Alzheimer’s or Parkinson's disease.

More than 10,000 living trust packages worth more than $200 million were sold by Alliance in California from 1991 on, the state alleged, with clients paying $1,000 to more than $2,000 for living trust packages, with commissions of up to 40 percent going to the sales agents. Agents allegedly used confidential information provided for the living trust to persuade the seniors to cash in IRAs, stocks, mutual funds and other saving accounts, investing those funds in annuities.

The Alliance settled by agreeing to pay a $100,000 penalty plus $1 million in restitution, and to stop selling living trusts. Two other insurers, Baltimore-based Fidelity and Guaranty Life Insurance Co. and Cincinnati-based Great American Life Insurance Co., settled earlier by agreeing to pay millions of dollars in penalties and restitution. But the bulk of the suit, seeking more than $200 million plus injunctive relief, was aimed at Fremont.

Justice Kathryn Doi Todd, writing for the Court of Appeal, rejected Fremont’s claims that the penalties -- a little more than $400 for each violation of the unfair business practices law as found by Sohigian -- were excessive and violated due process. The justice wrote:

"The misconduct was persistent and stretched over more than two years. The trial court found appellant knew of the connection between the estate plan sales and annuity sales and that its agents were engaging in the unauthorized practice of law. Appellant’s willfulness is evidenced by the fact that the disapproved language remained in the annuity policy after litigation commenced and appellant continued to collect the premium charges."

The appellate panel also upheld the trial judge’s order that full restitution, including interest, be offered to all purchasers. Fremont had argued that the order was improper because not all customers had been the victims of deceptive or unfair business practices.

There was, she said, sufficient evidence "to support a reasonable inference of class-wide deception or harm." She cited expert testimony by an actuary who testified that he could not understand the premium charge based on the information in the annuity policy. "This evidence alone supports the findings of the trial court that the annuity policy was ‘misleading and deceptive’ and therefore ‘likely to deceive’.

The California Attorney General issued an alert on February 18, 2003 warning seniors about "living trust mills" and annuity scams. Trust mill con artists try to make seniors believe their bank accounts are less safe than annuities or investments they're strongly encouraged to buy. Pretending to be living...
trust experts, such individuals work through assisted living centers, churches and other places where seniors gather. Sadly, more than a few seniors have paid large sums of money to dishonest agents.

A look into the mentality of those who target the elderly was provided by a recent Wall Street Journal article (July 2, 2002, p. C1). Believe it or not, there are training films and manuals that teach these disreputable people and firms how to prey on the elderly. Devious marketers are taught to manipulate the feelings of seniors by "tossing hand grenades into advice." The hustlers are counseled to "solve the [elderly clients'] problems, but...to create those problems first." Other manipulative plays include "Use words like protect, safety, and guarantee," and "Make them feel they are the most important persons in your life." The manual stresses that seminars where food is served are a good means of attracting business, as senior citizens "like freebies." Trainees are told that seniors "buy based on emotions...fear, anger, and greed."

Unethical marketers profit by exploiting the trust of the elderly, whom they pretend to serve. One training session advised students to sell to seniors by treating them "like they're blind 12-year-olds."

The Attorney General recently took action against several of these, and the Court entered a permanent injunction. Names associated with this misconduct are Alliance for Mature Americans, Alliance for Mature Americans Membership Advantage Corp., Adams Marketing Associates, Inc., and Stephen and Victoria Adams.

The latest scam involves other con artists who are now contacting people and claiming to be "authorized" by the Attorney General to take over for the Alliance. The Attorney General has made no such endorsements. He has, however, made some recommendations to avoid being victimized by dishonest vendors of this type:

- Be aware. Sales presentations made in churches or other places of trust are not necessarily legitimate. Facilities are frequently rented out to groups or individuals who have no connection to organizations usually housed there.
- Never sign documents on the spot. Have them reviewed by a third party. If a salesman refuses to leave them with you, curtail all negotiations immediately.
- Get promises in writing, dated and signed on behalf of the company by your salesperson.
- Refuse to allow a salesperson to rush your decision. Take whatever time you need.
- Discuss any transaction with a trusted advisor before committing yourself to it.
- Make a point of "comparison shopping."

Anyone who has a complaint against a company, has been defrauded, or has been contacted by someone claiming to be the successor of the Alliance for Mature Americans, should write to the Office of the Attorney General, Public Inquiry Unit, PO Box 944255, Sacramento, CA 94244.

Trust Mills are companies which "sell" expensive boilerplate estate planning documents which are not prepared by attorneys, are not appropriate for most of their clients, and are often defective. These trust mills operate under many different names and mainly target their "products" to seniors. These trust mills use the confidential financial information obtained to sell the client inappropriate investments. Some recent names these companies have used are National Trust Service, Alliance for Mature Americans, Legacy Legal, Estate Protection Planning Corporation, and Senior Informational Services.

Of great concern to the Legislature are abuses concerning the sales of financial products to the elderly, including annuities, Medicare supplement insurance and long-term care insurance. Unscrupulous con artists convince people to buy annuities and other insurance products, promising those products will avoid estate taxes and facilitate the Medi-Cal qualification procedure.

Many scams operate this way: "Free" seminars are sponsored to tell attendees how to avoid estate taxes. The operators begin by selling estate planning services such as living trusts. They then attempt to sell financial products such as annuities and life insurance policies in an attempt to earn commissions, often undisclosed. The danger is that these are not estate planning professionals but salesmen, who have little regard for whether they will be helped or harmed.

In an effort to assist and warn the public regarding estate planning scams and sales of unnecessary financial products, the California State Bar has established a phone number (1-888-460-SENIORS) where the public can ask advice or report a scam. In addition the State Bar has made a video entitled "Taking Charge." This video includes stories from...
three California families who suffered at the hands of these con artists. The stories and tips given will help people recognize the warning signs of an estate planning scam before it is too late.
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