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# Life Insurance: Protection Planning

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## What is life insurance?

Life insurance is a legal contract between an insurance company and a policyowner and is governed by state law. Under the terms of the policy contract, the policyowner pays premiums in exchange for the promise of payment of a specified amount of money to a named beneficiary when the insured dies. The policy itself contains provisions specifying the rights and obligations of the parties under the contract.

The specific purpose of life insurance is to replace the economic loss resulting from a person's death using money from a pool of funds to which many people contributed a relatively small amount.

## How does it work?

### *The application*

The first step to obtaining life insurance is completing the written application. Insurance companies typically inquire about a proposed insured's age, place of birth, home and business addresses, Social Security number, occupation, salary, tobacco, drugs and alcohol usage, bankruptcy, driving record, dangerous hobbies, travel outside the United States, other life insurance owned, and personal and immediate family medical history.

Today, insurers pool life insurance application and claims information in a database maintained by the MIB Group, (formerly, the Medical Information Bureau), a nonprofit membership organization of life insurance companies that operates an information clearinghouse on behalf of its members. When an application is submitted to a member life insurance company, the information on the application is compared to the MIB records from other companies' applications and claims information that the MIB has on the proposed insured. Insurance companies use this information to verify the information provided on the life insurance application as a means of preventing fraud.

Omitting a pre-existing medical condition or making any type of material misstatement may be grounds for denial of coverage. If the omission is discovered after the policy is issued, the insurer may be able to revoke the policy or increase the policyholder's premiums, depending on the amount of time that has passed since the issue of the policy and the discovery of the misstatement.

### *The medical exam*

Depending on the proposed insured's age, the amount of insurance the insured is buying, or other factors, a medical exam may be required after the application has been completed. The exam may include a physical exam, blood work, and EKG. Typically, the exam is performed by a licensed health professional that works for the insurance company. The insurance company usually pays for the exam and any lab work. The results are sent directly to the underwriter for review along with the proposed insured's application, although the proposed insured may request a copy.

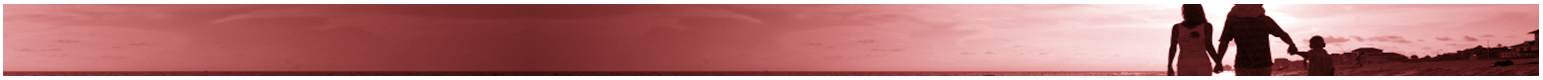
### *The underwriting process*

The job of an underwriter is to analyze the information provided by a proposed insured and the records and reports obtained regarding the proposed insured, decide whether the company should assume the risk of insuring that person, and if so, at what price. If an applicant is deemed a favorable risk, the application will be approved, the premiums will be set, and the policy will be issued.

### *The premium pool*

When an insurance company collects premiums from its policyholders, fees, expenses, mortality costs, and taxes are deducted and the balance of the money is pooled and invested in an account based on the policy type (e.g., whole life, universal life), and the terms stated in the individual policies.

When an insured person dies, a claim is filed with the insurance company that issued the policy. The insurance company pays the death benefit to the policy's beneficiary (there can be more than one), using money from the cash reserve of paid premiums and investment earnings.



# When can it be used?

## *Personal Uses--At Death*

### Provide for final expenses

Life insurance can provide cash for final expenses such as your funeral and burial costs (which normally averages between $5,000 and $10,000). As the following table shows, there are several ways to pay final expenses.

| Ways to Pay for Final Expenses | |
|---|---|
| Executor may borrow cash | Could end up costing more as the money borrowed plus interest may have to be repaid |
| Cash on hand | A great way to pay unless there's not enough cash to also pay other expenses and/or bequests |
| Sale of stock/investments | As assets generally receive a step up in tax basis, this could be advantageous but only if the investments are easily traded and not illiquid |
| Liquidation of tangible assets | May be difficult if there isn't a ready market for the assets. Further, a sale under pressure could result in having to sell the assets at less than fair market value. |
| Life insurance proceeds | Excellent way to pay because proceeds are generally paid promptly, received free of income tax, and if the required criteria are met, may be free of federal gift and estate tax |

### Provide financial support for dependents

A major reason for having life insurance is to provide financial protection for dependents that are left behind. When an individual dies, the financial support he or she provided to the family ends. However, the family's need for income continues. Most families will have an ongoing need for housing, transportation, medical care, food, clothing, and possibly education and day care.

### Pay off debt

The proceeds from life insurance can be used to pay off a home mortgage, automobile loan, credit cards, or any other debt that may have accumulated, relieving family members of the financial burden. Even persons who are single with no dependents should consider whether they could be leaving behind college loans or other debts for which co-signers may be held liable. Unfortunately, death does not relieve an estate of the deceased's contractual debt obligations. Insurance can provide the means to pay debts that are left behind.

### Pay estate taxes

Many people think that only wealthy people have estate tax concerns (e.g., those with sprawling mansions or vast corporate empires). The truth is, if your estate is large enough, it could be subject to federal and state estate taxes, depending on the applicable law at the time of your death. The following list contains some of the items that may make up your estate:

- Home(s)
- Cash
- Jewelry
- Assets owned with spouse, either as joint or community property
- Business
- Automobile(s)
- Investments
- Personal property
- Antiques, collectibles, etc.

Estate taxes can quickly erode the value of a sizeable estate. However, using life insurance in an estate plan can allow family members to avoid liquidating assets to pay these taxes.

### Create an estate

Life insurance can be used to create an estate when time or other circumstances have kept you from accumulating sufficient assets in excess of what is needed to provide day-to-day financial support for your family after your death. The premiums you pay for life insurance may be significantly less than the proceeds paid to your beneficiaries at death. The death benefit can be used to provide your beneficiaries with a larger legacy than might otherwise be possible.

## *Personal Uses--During Lifetime*

### Create retirement or college fund

When you buy cash value life insurance, you can receive certain lifetime benefits. Cash value life insurance policies include a potential accumulation of funds that can be accessed during your lifetime (e.g., for retirement savings or education savings) through loans or withdrawals. In addition, the cash value grows tax deferred, meaning you don't pay taxes on the increased value until you actually access the cash value, and even then the distributions may be subject to favorable income tax treatment.

## *Business Uses*

### Employee benefit program

Life insurance can be part of an employee benefit program, with coverage provided under a group plan. Many employers offer life insurance group coverage to employees at low or no cost to the employee. Often, the death benefit provided is a multiple of salary, such as two or three times annual gross salary.

***Caution:*** *Employer-provided coverage over $50,000 has certain tax consequences to the covered employee.*

### Key person coverage

Some companies take out life insurance polices on certain key employees, such as officers or managers. The purpose of the policy is to protect the company from the loss of talent, goodwill, and profit that can occur at the death of certain high-level employees. In addition to the loss of the employee, the company may face recruiting and training costs arising from filling the vacancy caused by the employee's death.

### Fund a buy-sell agreement

Life insurance can be used to fund a buy-sell agreement . Under a buy-sell agreement, life insurance can be used to provide cash for the purchase of a deceased owner's interest in the business, providing liquidity for the family of the deceased. If a cash value insurance policy is used, cash values may be accessed to help fund a buy out for a retiring partner's interest thereby creating a market for the retiring partner's interest.

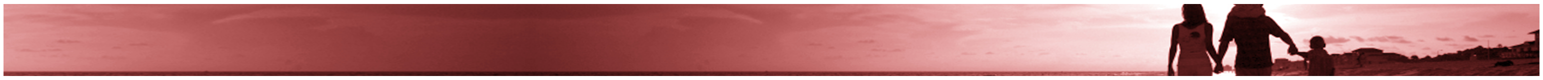
# How do you know what to buy?

## *Needs analysis*

The first step in determining what type or amount of insurance to buy is a "needs analysis." A financial professional can conduct a needs analysis to assess the financial impact on the family or business if the breadwinner or a key person in the business should die. The analysis will look at income-generating capability, current assets, debts, and ongoing expenses. Another consideration is your overall financial picture. This may include your goals for retirement, estate and tax planning, and education funding for any dependents, as well as your overall feelings about investments and risk. The results will indicate whether you have a need for insurance and how much insurance is appropriate. This picture will also direct you toward a specific life insurance policy type .

## *Affordability*

As important as it is to know how much insurance you need, consideration must be given to what you can afford. If you are in a situation where you have a high insurance need but low cash flow, there may still be a policy type available for you (e.g., term insurance), and you may have more options than you think.



# What are the potential life insurance mistakes?

## *No insurance*

As difficult as it is to face your own mortality, don't put off buying the life insurance protection your family needs. The proceeds from a life insurance policy can help your loved ones continue to manage financially during the difficult weeks, months, and years after your death.

## *Not enough insurance*

The second serious mistake is to not have enough life insurance. There are lots of ways this can occur, but there is an easy way to prevent the problem altogether. Periodically review your insurance coverage (e.g., every three years and at the occurrence of major lifetime events) to avoid (or correct) the situation of being underinsured.

## *Too much insurance*

It is possible to have too much insurance. This could happen if you purchased a large policy during one point in your life and then didn't adjust your coverage when your insurance need was reduced. This is another good reason to periodically review your coverage with your financial planning professional.

## *The wrong type of insurance*

There are two basic types of policies--term and cash value. Term insurance offers pure financial protection without a cash value component--the insurance company will only pay money if you die. On the other hand, cash value policies can provide both a death benefit and, after a set time period, the accumulated cash value if the policy is terminated. All other types of polices are some variation of these two basic types. Which type is the right type for you will depend on many factors including how long you need coverage and how much you can afford. Though it can be frustrating, you should take the time to understand the policy types and choose the one that will fulfill your particular needs.

# Tax considerations applicable to all types of life insurance

## *Tax code sets definition of life insurance*

In order to be considered life insurance and receive favorable treatment under the tax code, life insurance policies must fulfill certain criteria established by Congress. There are specific tests that must be met in order for a policy to be considered life insurance for tax purposes.

| **Tests of life insurance** | |
|---|---|
| **Cash value accumulation test** | Cash surrender value must not at any time exceed the value of the net single premium that would have to be paid to fund future benefits under the contract |
| **Guideline premium test** | The sum of premiums paid must not at any time exceed certain guideline levels |
| **Death benefit corridor test** | Contract death benefit must exceed a specified percentage of the cash surrender value at all times. The percentage varies according to the attained age of the insured. |

- Life insurance premium payments are generally not tax-deductible expenses for individuals or businesses
- Policy proceeds are generally received income tax free
- Transfer of a policy for value (as opposed to gifting the policy) can subject proceeds (excluding purchase price and subsequent premiums) to income tax

### Gift and Estate Tax

### *Policy proceeds not considered gift to beneficiary*

When the proceeds of your life insurance policy are paid to a beneficiary, they are not treated as a gift for federal gift and estate tax purposes. However, the insurance proceeds are generally included in your gross estate and may be subject to the tax and state death taxes as well.

### *Policy premium payments generally not subject to federal gift and estate tax*

When you are the owner of a policy on your own life, with another party as the beneficiary, premium payments made by you are not considered a gift to the beneficiary for federal gift and estate tax purposes. If, however, someone else pays the premiums on a policy you own, or you pay the premiums on a policy that is owned by someone other than you (e.g., a trust), the premium payments are considered gifts and may be subject to taxation. Policy premiums that are considered gifts generally qualify for the annual gift tax exclusion .

### *Policy proceeds included in estate value in most cases*

The proceeds of a life insurance policy on your own life are included in the value of your estate if you held any incidents of ownership at any time during the three years before your death, or if the proceeds are payable to your estate. Incidents of ownership include (but are not limited to) the right to change the beneficiary, take out policy loans, or surrender the policy for cash.

## Does it matter from which insurance company you buy your policy?

There are thousands of insurance companies in the marketplace and some are better than others in terms of financial strength and claims-paying ability. Premiums for similar amounts of coverage can also vary widely among companies. Your safest bet is to do some research before you pay money for a policy. Don't be afraid to ask questions. It's your money and your policy.

### *Check the ratings*

Many individuals will maintain life insurance for quite some time before there is a benefit payout. Therefore, it is necessary to thoroughly research several life insurance companies before deciding. Look for a company with a strong financial position and track record. The claims-paying ability rating is an indicator of the company's financial strength and how well prepared it is to pay on policy claims. The best insurance companies are those that have strong financial reserves (to pay claims) and have a history of paying claims promptly.

There are five major ratings services that monitor insurance companies: A. M. Best, Standard & Poor's, Fitch (formerly Duff & Phelps), Moody's, and The Street.com (formerly Weiss). Each company has a different rating system. Rating information is available in most public libraries (check the business reference section) as well as through various published sources, some of which may be found on the Internet.

### *Look at service reputation*

Service is an important factor in determining customer satisfaction--even if no action is necessary. Find out how long the company takes to process and pay claims. Check with the consumer division of the department of insurance in your state to find out about complaints (and how they were resolved) or about disciplinary action against a particular agent, broker, or insurance company. And finally, ask friends and family members who they use and how they found out about the company.

## IMPORTANT DISCLOSURES

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