Course Overview

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners, and insurance advisors) about a topic most non-insurance advisors despise, e.g. life insurance. Most non-insurance advisors think of many life insurance agents as product pushers who are looking out for their own good. The opinion mainly comes out of a lack of understanding about how life insurance works and how it can benefit clients.

The following material will explain to advisors the basics that hold true for all life insurance policies, and then specific information which differentiates Term, Whole, Universal and Variable life Insurance policies. The material will also cover several new types of life insurance policies and why these policies are in many cases better than the traditional policies that have been sold for over 20 years. The new types of policies are Return of Premium Term, No-Cash Value Universal Life and Equity Indexed Universal Life.

Non-insurance advisors who read and understand the following material will no longer have to wonder if the local life insurance agents are doing what is in their client's best interests or what is in the insurance advisor's best interest.

Life Insurance

Introduction

There are many types of life insurance policies available in the marketplace today. We will cover them in this material and break them down in 2 categories, the originals and the hybrids. In addition to the types of products, we will also be covering Riders and the most important factors when utilizing a life product while doing a financial or estate plan for clients.

Life insurance can be one of the best and simple estate and financial planning tools we have available for our clients. What other planning tool do we have at our disposal that in day one, we can make a monthly premium of $500 and have an immediate payout to a beneficiary of $1,000,000 dollars? What other product can we use in a supplemental retirement plan that is self completing?

What does self completing mean? Three things can happen to your clients after they buy a life insurance policy. They can live, die or become disabled. A properly structured life plan can provide or complete itself for your client no matter which of the three happens. Either they or their beneficiaries will receive monies from the policy.

Another simple structure is the immediate positive arbitrage clients receive when a permanent life policy is combined with a SPIA (Single Premium Immediate Annuity). The loan provisions available on cash values can often be

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

at net zero cost to the client (via wash loans). Also, the creditor protection provisions of some states make life insurance a protected asset from creditors; and in states that do not asset protect life insurance, the client can use a simple LLC structure to asset protect the cash value in the life policy (see the "advanced" estate planning module for an explanation of the LLC structure).

In the following pages we will discuss the types of life products available so readers will see why the words "Life Insurance" should not be taboo.

The Basics

The material to follow goes into detail on the various types of life insurance, how they work and who is a candidate for each type of policy. Before getting into the more detailed information, the basic concept of how a death benefit is paid needs to be dealt with. The following applies to every type of individual life insurance policy.

Proceeds Payable at Insured's Death

On of the unique and beneficial aspects of life insurance is that the death benefit, when paid to the beneficiary, is generally done so income tax free (IRC Section 101(a)(1)). This favorable tax treatment applies even if the proceeds are paid to the insured's estate or to a corporation or partnership, trust, LLC, or other entity, rather than to one or more individuals. The proceeds are income tax free regardless of whether paid in a lump sum or in installments, although any interest earned is taxable. Death benefits paid from term riders or paid-up additional insurance are likewise income tax free as are payments from an accidental death ("double indemnity") rider and group term life insurance.

There are some exceptions to the general rule that life insurance death benefits are be paid income tax free. These include life insurance purchased in conjunction with employment, or that purchased in a qualified retirement plan, which is discussed in the education module on the Qualified Plan Insurance Partnership (QPIP®).

While death benefits generally pay income tax free to the beneficiary, they will not pass estate tax free through the estate to heirs that are not the living spouse of a client unless the policy is owned by an irrevocable life insurance trust (ILIT). Life insurance properly owned and funded by an ILIT will pass income **and** estate tax free to the beneficiaries. For more information on ILITs, please see the educational module on estate planning.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

Type of Life Insurance Policies

The Originals

The two original types of insurance are Term Insurance (insurance for a specified period of time) and Whole Life Insurance (Insurance coverage guaranteed for the duration of your life). Both products are used in planning, and depending on a client's situation one may work better than the other. Even though it somewhat of a hybrid, we will also cover Return of Premium Term (which returns all premiums paid at the end of the term) in the section on term insurance.

Term Life Insurance

Term Life Insurance is thought of as a simple product. It obviously has to be if people are purchasing it by droves on the internet and from television commercials, right? While most clients and non-insurance advisors think of term as simple, it is not as simple as it seems due to some important factors that many times should not be overlooked.

A simple explanation of term is that the client pays a set insurance premium for a certain period of time (the term); if the client passes away during that term, the beneficiaries receive the death benefit. If the client does not die during the term there is no refund of premium unless the policy is the new kind of term life called ROP (Return of Premium) Term. They simply paid the cost of insurance during that period and received no financial benefit (except for the peace of mind).

As we address the three major types of term insurance; Guaranteed Level, Annually Renewable, and ROP, in detail we will also show a comparative illustration so you can see what current pricing is and why one might make more sense for the client than the other. We will use one carrier for these examples.

Please keep in mind that, as with any good or service we purchase, cheaper isn't always better. Don't be so quick to rush to the lowest cost term product without knowing how the company is rated, how they deal with underwriting (especially if a client is not completely healthy), and how long it takes a company to issue a policy (some take months to issue even the simplest term policies). For the non-insurance advisors, an experienced life agent with the support of a good General Agency (GA) should be able to point you and your clients in the proper direction.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

Guaranteed Level Term (GLT)

This is the most common used term life insurance today. Guaranteed level term has a scheduled (set) **premium** for the complete term, which is set at the beginning of the contract. Generally the terms are 5,10,15,20, or 30 years. Different carriers sometimes do not offer all these options. At the end of the term the client does not receive a return or refund of any premiums paid and is left with no insurance coverage.

Annually Renewable Term (ART)

Annually Renewable Term is not commonly used anymore despite its extremely low cost to the client (ART is the **least expensive** type of new life insurance policy a client can purchase in any given year). ART used to be a popular policy because it has the lowest cost during the first few years of the policy.

The problem with ART is that the policy renews (re-prices) itself every year. While a client does not have to go through underwriting to keep the policy for the period purchased, from an economic standpoint, it is like the client is buying a new policy every year. The older the client gets, the more the policy costs. At some point an ART policy will cross over and cost more each year than a guaranteed level premium policy. The crossover point will vary depending on the age of the client.

For example, let's say a client is 30 years old and the cost of 20 year regular GLT costs $600 for $1,000,000 in death benefit. That means if the client pays $600 dollars a year for 20 years, the client will have $1,000,000 in coverage in force for the full 20 years. If a client purchases 20 year ART, the first year premium would be much lower, let's say $250. That premium would increase each year, and eventually would begin to cost more than that the GLT. This is the crossover point. After the crossover point ART will always cost more than GLT.

As a general statement, GLT is always a better option for clients who believe they will keep the life policy for the contract term. ART is usually purchased by clients who have very little money and need insurance. They also usually hope that, in the near future, they will have more money so they can buy a GLT policy so they can afford to keep it for the entire term.

Also, at the end of the guaranteed term the client does not receive any return or refund of any premiums; and unless the client does accepts the tremendous increase in premium as the policy becomes an ART, they will no longer have life insurance coverage.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

Return of Premium Term (ROPT)

Purchase "Free" Term Life Insurance with a Return of Premium Rider

The vast majority of clients under the age of 60 have purchased term life insurance at one time or another. Usually clients purchase 10-30 year level term insurance (where the premium is constant for 10-30 years) because it is the most inexpensive way to fund a death benefit without increasing costs for a specific period of time.

While most clients purchase level term life insurance, they also despise the concept of term life because they do not believe death will occur during the term of coverage. Therefore, they view the premiums, at the end of the period, were a total waste (although the client did have peace of mind while insured).

Insurance companies love to sell term life. Depending on the statistics you will read, nearly 93% of all clients who buy term insurance do not die during the coverage period. That means that when clients purchase term life insurance, they have a 93% chance that the premiums will be a waste of money.

A few select companies have come out with Return of Premium Term Life Insurance (ROPT). ROPT is very simple to understand. You pay a premium that is marginally higher than the normal level term life costs and, if you do not die, you get the premium returned to you in full. ROPT life is for clients who know they need coverage only for a specified period of time, know that the premium is more expensive than traditional term life, and know that the death benefit is probably not going to be available after the client turns 70 (a time when many high net worth clients need permanent life insurance to pay for estate taxes).

The rub is that the client does not get investment growth on the difference in premium paid between regular term and ROPT. Depending on the number, ROPT can work out well financially for a client or not so well.

Let's look at an **example**:

Assume Dr. John Smith is age 38, has two children, and a wife. His total assets are less than $1,000,000; and he wants to make sure that, were he to die in the next 20-30 years, his spouse and children would be taken care of; the house payment and bills would be paid; the children would be able to go to college, have nice clothes, drive nice cars; and the spouse would not have to go to work in order to provide for the children and herself. Dr. Smith would have purchased 20-30 year level term to take care of those needs until he found out about the ROPT.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

	Term Life Life Cost	Return of Premium Term Life Cost
30 Year Level Term Life	$2,400 (per year)	$3,940(per year)
Total cost for 30 years	$72,000	$118,200

Premium Difference	($46,200) over 30 years ($1,540) per year

Interpreting the numbers:

The amount of premium paid per year would be $1,540 more with the ROPT. Automatically, most clients would resort to their default position; always opt for the less expensive product when it comes to insurance and invest the difference in the stock market.

If Dr. Smith invested the difference in premium, $1,540 per year for the 30-year period, he would have approximately $88,255 after tax (capital gains and dividend taxes) assuming a 6% annual investment return.

If he chose the ROPT and did not die, he would receive a guaranteed return of premium of $118,200 income tax free.

The difference between the amount in Dr. Smith's brokerage account ($88,255) and ROPT ($118,200) = $29,945.

(Remember that while Dr. Smith was investing the difference in premium ($1,540) each year, he still would have had to pay his traditional level term life premiums of $2,400 each year for 30 years. When you add the $2,400 traditional level term costs with the amount invested in the above example ($1,540) you get the annual ROPT premium of $3,940).

Final numbers: Dr. Smith would have to earn in excess of 6% pre-tax in the stock market with the difference in premium ($1,540) in order to have more money than he would receive with his ROPT. And Dr. Smith has NO guarantee that his money in the stock market will not earn less than 6%, or even negative returns, as we saw in 2000-2003.

Here is another example of the premium differences between ROPT and guaranteed level term. Keep in mind that, normally, ROPT does not work well unless the client is considering at least a 20 year term.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

Year	Age	Male Preferred $1,000,000	Guaranteed Level Term 20 year	Return of Premium Term 20 year
1	44		$1,150	$2,130
2	45		$1,150	$2,130
3	46		$1,150	$2,130
4	47		$1,150	$2,130
5	48		$1,150	$2,130
6	49		$1,150	$2,130
7	50		$1,150	$2,130
8	51		$1,150	$2,130
9	52		$1,150	$2,130
10	53		$1,150	$2,130
11	54		$1,150	$2,130
12	55		$1,150	$2,130
13	56		$1,150	$2,130
14	57		$1,150	$2,130
15	58		$1,150	$2,130
16	59		$1,150	$2,130
17	60		$1,150	$2,130
18	61		$1,150	$2,130
19	62		$1,150	$2,130
20	63		$1,150	$2,130
Total Premium Paid			$23,000	$42,600

The illustration above is a side by side comparison between GLT and ROP term. The Illustration assumes a Male, Age 44, Preferred Non-Smoker, in the state of MI.

As you can see the GLT premium is lower that the ROPT (It always will be). However, as we discussed above, at the end of the 20 years, assuming the client is still alive , he will receive a refund of the total premium paid in, in this case, $42,600. Once properly explained, almost all clients like the concept of ROPT; the question is whether the product is a good fit.

Many advisors will still use the GLT product opposed to the ROPT due to three factors. First, as amazing as this sounds; many life insurance agents are not familiar with the product due to the fact that they are “captive” agents (by contract, greed or mentality) and the company(s) the agent uses does not have return of premium.

Second, many agents who are familiar with ROPT do not sell it because the commissionable premium is less (sad but true).

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

Lastly and the most valid reason for not recommending ROPT is the issue of Conversion Privileges. **Conversion Privileges** are an extremely important feature on term contracts regardless of the type. For many clients it is advisable they only buy policies that allow for conversions and it is important when reviewing any kind of term life policy to make sure the client has a right to convert at the end of the term.

Conclusion on ROPT

If your clients despise paying term life insurance premiums due to the fact that there is a 93% chance they will not die and therefore the premium was a waste of money, then you should recommend that they consider ROPT. With ROPT, your clients are getting **free death benefit** coverage due to the fact that they will receive every dollar paid in premium back via the Return of Premium Rider. This will allow your clients to avoid the feeling that they could make better use of the money by making a bonfire with it and roasting marshmallows (we all assume we will be in the 93% category of people who did not die during the term period).

What about future coverage if the client does not die by the end of the term?

The conversion privilege is exactly what it sounds like, a right to convert the life policy into another policy. It is the right of a client to convert a term policy into a permanent insurance product (Universal Life, Variable Life, or Whole Life) that the same carrier has to offer. The conversion is guaranteed **regardless of health at time of conversion and is the most important element of a term life policy**. The question then becomes, what policy should the client convert to? A conversion right is vitally important in case the client nears the end of the term and then is diagnosed with a disease, such as cancer, or other deadly disease, which would preclude the purchase of a new policy.

A client may convert to a permanent product at the underwriting class of the term product, priced at the client's current age. Determining which product type the client has the ability to convert to is very important, and should be a principal factor when deciding which carrier the client should use. If an insurance company has limited options; or poorly designed UL, VUL or WL policies, a client would want to look at a company with better options.

Conversion privileges differ with each carrier, but, generally, they offer conversion privilege up to year five after contract issue. Some contracts will offer longer periods, but five years is the rule of thumb.

Who should buy a term policy with a conversion option? One who believes that they will ultimately need a permanent death benefit. That client should be shown the best permanent product for their needs, and GLT with conversion privileges to that product, purchased from that carrier.

Conclusion on term life

Many clients who anticipate having significant wealth accumulated after 20 or more years of working will probably believe they will not need life insurance after their children leave college. The main reason for term life in the first place was to take care of the spouse and kids until the children got out of college, and the client believes the estate may be several million dollars by the time the children reach the age of 22+.

High income and educated clients also believe they can do proper estate planning to avoid the need to buy life insurance to cover estate taxes. Therefore, if the client will not need life insurance after the children get out of college, and will not need life insurance for estate planning, what is the cheapest way out? Term life and, more specifically, ROPT, due to the fact that the client will receive the premium back at the end of the term.

Things you need to know before discussing cash value life insurance policies

A cash value policy is a whole life, universal life, or variable life insurance policy. In short, the client pays a planned premium, and some portion of the premium will go towards the cash value, which earns interest either at an annually declared rate or a rate that fluctuates due to stock market returns such as those in variable life policies.

1) Cash Surrender Value (CSV)

The CSV of a policy is the amount of cash the client would receive if he/she decided give up or terminate the life policy. The CSV in the early years of a life policy (typically years 1-10 and sometimes up to year 15) is always less than the cash account value (CAV**). A good rule of thumb is that the CSV will equal the cash account value in year 10**.

The CSV is lower in the early years to make sure the company stays profitable in case a client chooses to surrender the policy. The difference between the CSV and CAV comes from the fact that the insurance company has underwriting expenses, has to pay commissions to insurance agents, and has taxes to pay.

2) Cash Account Value (CAV)

The CAV in a life policy is the amount of money the company allocates to a client's growth account. The cash account value is always higher than the cash surrender value in the early years of the policy. The client does not have

access to the cash account values until the "surrender" charges in the policy are gone (which is usually at the end of year 10 in most policies).

The CAV is really what grows inside a non-term life policy. If there are investment returns inside the policy they are credited to the CAV. Then the insurance company applies its scheduled penalty (surrender charge) to the CAV to calculate the client's CSV. If a client plans to keep the policy in place for more than 10 years, typically the surrender charge is not an issue.

3) Policy Withdrawals

A withdrawal is the partial surrender of a policy. A policy owner will not have taxable income until withdrawals (including previous withdrawals and other tax free distributions from the policy such as dividends) made from the cash reserves of a "flexible premium" (i.e., universal or adjustable life) policy exceed the policy owner's cost (accumulated premiums). Until the policy owner has recovered his aggregate premium cost, he will generally be allowed to receive withdrawals tax free under what is known as the "cost-recovery first" rule.

But, this income tax liability is accelerated if a cash distribution occurs within 15 years of the policy's issue and the distribution is coupled with a reduction in the policy's contractual death benefits. A withdrawal within 15 years of policy issuance coupled with a drop in death benefits triggers taxable income. Subject to a statutory ceiling, all the income growth in the cash surrender value is deemed to have been received by the policy owner. Once the 15 year period expires, no immediate taxation will occur upon a withdrawal.

This 15 year rule does not apply to policies issued prior to 1985. Nor does this 15 year rule apply to policy loans. This is because loans are not treated as distributions and do not reduce policy death benefits.

A notable exception to the "cost-recovery" rule applies to life insurance contracts classified as modified endowment contracts (MECs), which are covered in more detail below. For more specific information on the withdrawal rules see Revenue Ruling 2003-95.

4) Modified Endowment Contract (MEC)

To better understand the following discussion of the MEC rules, consider this question: what is the best investment in the world? The answer is one where money can grow tax free and be taken out tax free.

Assume you have a 45 year old male client looking to invest $100,000 somewhere. The client could invest in the stock market, in mutual funds, or real estate. If he does that, he will have to deal with capital gains taxes and or dividend taxes, which will hinder the ability of the money to grow annually.

What about investing in a cash value life insurance policy? What if the client could pay a $100,000 premium, receive a $105,000 death benefit and have $99,000 growing in the life policy totally tax free? What if after ten years the amount of cash in the life policy had grown to $250,000 and the client could access that cash income tax free? Would that be a good investment? The answer is absolutely yes, and in the “old days” that’s just about what was happening in the insurance industry.

To counteract what was perceived as an abusive use of single-premium, limited-pay, and universal life policies as short-term tax-sheltered cash accumulation or savings vehicles, Congress passed legislation modifying Code section 7702. This Code section provides the tax law definition of a life insurance contract, and the modification created Code section 7702A, which defines a new class of insurance contracts called modified endowment contracts (MECs).

The basic difference between MECs and other life insurance contracts is the federal income tax treatment of amounts received during the insured’s life. Certain “distributions under the contract” that are not generally subject to tax when received from other life insurance contracts are subject to income tax and, in some cases, a 10-percent penalty when received from MECs.

In other respects, MECs are treated and taxed under the same rules that apply to other life insurance contracts that are not MECs. Basically, compared with policies that are not classified as MECs, MECs have detrimental tax consequences for some living benefits but the tax treatment of cash accumulations within the policy and death benefits is no different than for other policies.

What is a MEC? MECs are policies that meet the Section 7702 definition of life insurance and are funded more rapidly than a paid-up policy based on seven statutorily-defined level annual premiums.

The basic rules are:

1. Policies “entered into” before June 21, 1988, are grandfathered from the MEC rules unless they undergo a “material” change.

2. All policies entered into after June 20, 1988, and any policy, whenever issued, that undergoes a material change, must be tested under the MEC classification rules.

3. **Once a policy is classified as a MEC, it remains a MEC. A MEC will not change its MEC status if it is changed, adjusted, or reconfigured as a policy that would otherwise not be classified as a MEC.**

4. A policy received in exchange for a MEC is also a MEC, even if the policy that is received would otherwise not be classified as a MEC.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

MEC tax treatment

The tax treatment of certain amounts received from MECs prior to death —called distributions under the contract— is equivalent to the tax treatment afforded premature annuity distributions. To the extent of gain in the policy, such amounts are taxed on an income-first basis. In other words, the first distributions out of the contract are **not** considered a tax free return of the policy owner's cost but rather the investment earnings on the contract. Those earnings are deemed to be withdrawn, and therefore become taxable, before the policy owner can recover his or her tax free basis. So, only after **all** income or gain in the policy has been received are additional amounts treated as nontaxable return of the policy owner's cost basis or investment in the contract.

In addition to the tax on distributions under the contract, a second tax is imposed in certain cases. This second tax is a 10-percent penalty tax. It is imposed on amounts received that are included in gross income.

This 10-percent penalty tax does not apply to any distribution:

1. made on or after a taxpayer attains age 59½ years of age, or

2. attributable to a taxpayer's becoming disabled, or

3. which is part of a series of substantially equal periodic payments made for the life (or life expectancy) of the taxpayer or for the joint lives (or life expectancies) of the taxpayer and beneficiary.

Generally, gain in the contract is determined by subtracting adjusted premiums paid from policy cash values. Adjusted premiums are total premiums paid (excluding premiums paid for supplementary benefits such as waiver of premium and accidental death benefit features) less any dividends received in cash or credited against premiums and less the nontaxable portion of any previous withdrawals. Cash value is computed without regard to surrender charges and so, for this purpose, is really the policy's reserve or account value. Therefore, gain may exist and result in taxation of a distribution even though a policy owner cannot actually access it. Also, in some cases a full surrender could yield less tax than a partial withdrawal.

Amounts received that are treated as income-first distributions under the contract include:

1. **policy loans** (to pay premiums as well as for all other purposes);

2. loans secured by the contract;

3. interest accrued on a policy loan;

4. withdrawals;

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

5. cash dividends; and

6. dividends retained by the insurer as principal or interest on a policy loan.

Amounts received that are **not** treated as income-first distributions under the contract include:

1. dividends retained by the insurer to pay premiums or other consideration for the contract;

2. dividends used to purchase paid-up additions, term insurance, or other qualified additional benefits; and

3. surrender of paid-up additions to pay premiums. However, it should be noted that the status of surrendering paid-up additions to pay premiums is uncertain. Most commentators feel they are not income-first distributions under the contract, but the issue has not yet been completely settled.

MEC tax treatment applies to amounts received during the contract year in which a policy effectively becomes a MEC, as well as to amounts received in any subsequent contract year. It also applies to any distributions in the two years before the policy fails the seven-pay test.

Example: Kathy purchased a life insurance contract on January 1, 1999. As of January 1, 2001, her basis in the policy is $100,000. The contract has a cash value of $140,000. The policy is a MEC. She borrows $50,000 from the policy's cash value on her 50th birthday. Kathy's taxable gain from the loan is $40,000 ($140,000 cash value – $100,000 basis in the policy). If Kathy is in the 28 percent income tax bracket, she must pay an income tax of $11,200 ($40,000 x 0.28). She must also pay a 10 percent penalty on the taxable amount. The penalty will be $4,000 ($40,000 x .10). Therefore Kathy's total tax bill on the loan from the policy is $15,200 ($11,200 + $4,000). Note that all amounts included in Kathy's gross income as a result of taking a loan from the policy will be added to her basis in the policy for purposes of determining future taxable amounts. Therefore Kathy's basis in the policy after taking the loan will be $140,000 ($100,000 original basis + $40,000 taxable portion of loan). The $10,000 nontaxable portion does not affect Kathy's basis in the contract because the transaction is a loan and not a withdrawal.

Technical definition of a modified endowment contract

A MEC is a life insurance contract that meets the requirements of Code section 7702 and:

1. was entered into on or after June 20, 1988, and fails to meet the seven-pay test, or

2. is received in exchange for a MEC.

A policy that originally satisfies the seven-pay test in its first seven contract years may nonetheless become a MEC if it undergoes certain material changes, which are described below. Policies that undergo material changes are subjected to a new seven-pay test.

The seven-pay test

The test for MEC status is called the "seven-pay" test. The seven-pay test must be applied in basically three situations:

1. To initially test policies entered into after June 20, 1988;

2. To retest policies entered into after June 20, 1988 if death benefits are reduced within the first seven contract years; and

3. To test or retest *any* policy, even those entered into before June 21, 1988, when there is a material change in future benefits.

Initial test for policies entered into after June 20, 1988

A contract fails to meet the seven-pay test if the accumulated amount paid under the contract at any time during the first seven contract years exceeds the sum of the "net level premiums" which would have been paid on or before such time if the contract provided for paid-up future benefits after the payment of seven level annual premiums. Generally, "amount paid" is defined as the premiums paid under the contract reduced by any distributions, but not including amounts includable in gross income. For purposes of this test, the death benefit for the first contract year is deemed to be provided until the maturity date without regard to any scheduled reduction after the first seven contract years. However, certain limited scheduled increases in death benefits may be taken into account.

Example: If the annual net level premium for a $100,000 death benefit seven-pay policy is $4,500, then any $100,000 policy for the same insured on which aggregate premiums exceed $4,500 during the first year, $9,000 during the first 2 policy years, $13,500 during the first 3 policy years, $18,000 during the first 4 policy years, $22,500 during the first 5 policy years, $27,000 during the first 6 policy years, or $31,500 during the first seven years of the policy will be considered a modified endowment contract.

The seven-pay test does not require that a policy provide for seven level annual premiums to be paid over seven years. Rather, the test limits the cumulative amount that may be paid for each of the first seven years. Premiums may not be paid in advance in an amount that violates the annual premium limit. However, it is possible to make up for premiums paid in prior years that were less than the maximum amount permitted.

If the aggregate premiums paid during the first seven years are less than aggregate premiums that would have been paid on a level annual-premium basis using the net level premium amount ($4,500 a year in this example) for a seven-pay policy (for the same insured), the policy will not be a modified endowment contract and will receive the same tax treatment previously applicable to all policies.

Definition of Net Level Premium

The definition of a net level premium under these new rules is based on the guideline level premium concept under Code section 7702. The net level premium is not the same as the actual premium payable under the contract. It is also not the same as what many life insurance agents refer to as a net premium. "Net level premium" is a technical term of art that refers to an artificially constructed net level premium that is computed using mandated interest, mortality, and expense assumptions. Therefore, it is possible that even policies that require seven level annual premiums will not pass the seven-pay test in some cases, because the artificial net level premium (as calculated under the regulations) will be less than the actual premium. In other words, if the net level premium is less than the actual premium payable, the payment of the actual premium due will cause the policy to fail the seven-pay test.

Riders to policies are considered part of the base insurance policy for purposes of the seven-pay test. Since the cost of such riders will be included in the calculation of the seven-pay test, a term rider may help a policy avoid classification as a MEC. Examples of such riders would be guaranteed insurability, family term, accidental death or disability, disability waiver, or other allowed benefits.

Refund of Excess Premiums

If the insurer returns premiums paid in excess of the net level annual premium limit plus the interest on the excess premiums within a 60-day grace period of the end of the contract year in which the excess occurs, the contract will not fail the seven-pay test. The returned amount will reduce the sum of premiums paid under the contract during such contract year for purposes of the seven-pay test. Interest paid will be includable in the gross income of the recipient.

Most insurance company software has a feature that an agent can click on to make sure a policy is not a MEC. If the agent inputs a premium amount over a period of years for a specific death benefit that would cause the policy to become a MEC, the software typically will withdrawal cash from the policy in the year the policy is to become a MEC to prevent the policy from becoming a MEC.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

Benefit reductions within the first seven contract years

If death benefits are reduced within the seven-year testing period, there is a look-back requirement. The seven-pay test must be reapplied as if the contract originally had been issued for the reduced benefit amount.

Example: Assume the guideline annual premium is $10,000 based on the original death benefit. The policy owner pays $9,000 each year for the first 6 years. In year seven, the policy owner withdraws $36,000, with a corresponding decrease in the death benefit. The recomputed guideline premium is $8,000. The policy now fails the seven-pay test and is a MEC since cumulative premiums paid in just the first year, $9,000, (and through year 6 as well) exceed the sum of the recomputed guideline annual premiums of $8,000. The $36,000 withdrawal will be subject to tax to the extent of gain in the policy. If the policy owner is under age 59½, a 10 percent penalty will also be imposed on the taxable portion of the distribution.

The seven-year rule for benefit reductions appears to apply only during the first seven contract years unless there is a material change. Therefore, absent a material change, a benefit reduction after the first seven years has **no effect**. A benefit reduction itself is not a material change. However, a material change may restart the seven-year look-back period for benefit reductions because a material change is treated like a new policy issuance. Apparently, benefit reductions within the first seven years after a material change will require a re-computation of the seven-pay test back to the date of the material change rather than the policy's original issue date, even if the periods overlap.

Reductions of Benefits Attributable to Nonpayment of Premiums

Any benefit reductions attributable to the nonpayment of premiums due are not taken into account if the benefits are reinstated within 90 days after being reduced. This rule applies to a non-forfeiture option of reduced paid-up insurance within the first seven contract years. In other words, if a policy that is put on reduced paid-up status fails the seven-pay test as a result of the look-back rule, the failure may be reversed if the policy is reinstated to its original death benefit within 90 days. Alternatively, failure of the test could probably be avoided by electing the extended term option rather than the reduced paid-up option. The policy could also be surrendered without adverse consequences since the complete surrender of a life insurance policy during the policy's first seven years is generally not considered to cause the policy to be treated as a MEC.

Conclusion on the MEC rules

Since a good portion of the cash value life insurance policies sold in this country are sold on the premise that the policy owner will be able to take out tax free loans in retirement, it is vitally important for advisors to understand how the

MEC rules work, and what to do to help clients avoid having their life insurance policies become MECs. While the previous material may seem a bit detailed, knowing the information can prove invaluable when helping a client avoid having a policy become a MEC.

5) Policy Loans

When a client is sold a non-MEC cash building life policy, the sale, in large part, usually revolves around "loans" that can be taken from the policy "income-tax free." These loans are called wash loans.

Clients **pay NO income tax if they borrow cash value from their life insurance policy** through loans. Generally, loans are treated as debts, not taxable distributions. This can give clients virtually unlimited access to cash value on a tax-advantaged basis. Also, these loans need not be repaid. After a sizable amount of cash value has built up, it can be borrowed systematically to help supplement retirement income. In most cases the client will never pay one cent of income tax on the gain.

There are several cautions regarding policy loans: First, loans are charged interest and can reduce the overall value of the policy. Second, the cash value is potentially subject to income taxes when there is a withdrawal from or surrender of the policy, or if a certain ratio of death benefit to cash value is not maintained. Third, if the policy is a modified endowment contract, the loan may be taxable.

Many companies have created what are called "**wash loans**" to make the borrowing from a life insurance policy more saleable. Let's look at the following non-wash loan situation.

If a client has $200,000 worth of cash surrender value in the life policy, the client could call the insurance company and request a "tax free" loan from the policy. Let's say that loan is $10,000. The insurance company has to charge interest in the policy on the borrowed money. If loan rates are 8% then the client policy is charged 8% interest on the loan and that must be paid every year. The cash in the policy is still growing but at what rate? If the crediting rate in the life policy is only 6%, then there will be a shortfall on the interest owed and the cash value will start to go backwards (and usually the client will expect to pay back the loan at death).

If the client had a wash loan, the interest charged on the loan would equal the growth rate on the cash in the policy, so the cash in the policy will not have to be used to pay the interest on the loan. So, if the interest on the loan is 8%, the insurance company will credit 8% on the same amount of cash in the life policy so it is a neutral transaction from the client's point of view. The life policy was charged 8% on the $10,000 loan, but the life policy also earned 8% on $10,000 in the policy to create this neutral situation. If you have clients who intend to borrow money from their life insurance policies, make sure to select a company that has wash loans.

Cash Value Life Insurance

-Whole Life Insurance

Whole Life (WL) insurance has almost become the forgotten child in the insurance industry. Not many companies offer the product any longer due to the ever increasing demand for lower cost Universal Life policies (UL).

Very recently, clients and advisors are demanding a whole life policy with death benefit guarantees and strong cash values that can grow in a conservative manner. Where can the client go to get such a policy? One option is the newer and more competitive WL policies.

Whole life insurance companies pay "dividends" to policyholders when the insurer's investments perform better than expected. Unlike a dividend your clients would receive on a stock or mutual fund, a dividend paid on a life insurance policy is a return of premiums your clients previously paid. The insurance company returns an annual policy dividend to the policyholder based on the investment, mortality and expense performance of the company. The final cost of the insurance will only be known upon death of the insured.

Many advisors who like the guarantees in whole life believe there is no better way to accumulate cash values while guaranteeing death benefits, especially in Short-Pay scenarios.

Whole Life insurance is simple in definition; it guarantees the death benefit for the whole life of the client. Dividends from the company are payable into the policy which can either increase cash values or purchase Paid-Up Additions (additional Insurance). There are several types of whole life insurance such as 10 and 20 pay, and full pay. We will discuss these types of whole life policies in this section.

10 Pay and 20 pay Whole Lives

This is a contract with a level premium payable for either 10 or 20 years, and a death benefit guaranteed for life. There is potential for strong cash value and payment of dividends. These shorter pay structures are generally used in advanced market cases such as premium financing, where high cash values in early years are needed to offset collateral requirements.

Full Pay Whole Life

This is a level premium payable for the life of the contract and the death benefit is guaranteed for life. There is potential for strong cash value and payment of dividends. Generally, it will take longer for a full pay contract to generate cash values which are stronger than the values in 10 or 20 pay whole life contracts. If dividends reach high amounts in late years the client will have

the ability to use those dividends to offset premium costs or to pay for additional paid up death benefit.

Whole Life Insurance Conclusion

Whole life insurance can be a nice way for clients to obtain a guaranteed death benefit while accumulating cash in a stable dividend environment. Whole life can also work well in short pay scenarios due to the higher expenses in the policies which can help avoid the life insurance policy from becoming a modified endowment contract. While it is counter intuitive, higher costs in a life policy early on can actually be a benefit to clients. As a general rule of thumb, the costs in a whole life policy are higher in the early years (as compared to a UL or VUL) and lower in the later years of the policy (as compared to a UL or VUL).

As we mentioned, not many carriers are currently offering whole life products and even fewer General Agencies have carriers and products to offer. Even though you may have to search for the right product for your client, do not ignore this “Old School” product when there is a need for specific clients.

The Hybrids

The insurance industry, in order to stay on top with current trends, invented new product classes from the 1980’s to present day. Since the products essentially combine features from term and whole life insurance, we will call them Hybrids

Let’s review some of the hybrid products and determine which might be the best fit for certain clients. The Hybrids are: Fixed Universal Life Insurance, Variable Universal Life Insurance, and Equity Indexed Universal Life Insurance.

Fixed Universal Life

Developed originally in the early 1980s, Universal Life (UL insurance) combines the low-cost protection of term insurance with a savings component invested in a tax-deferred account, the cash value of which may be available for a loan to the policyholder. Universal life was created to provide more flexibility than whole life by allowing the holder to shift money between the insurance and savings components of the policy.

Additionally, the inner workings of the investment process are openly displayed to the holder, whereas details of whole life investments tend to be obscure. The premiums, which may be variable, are divided into insurance and savings. Therefore, the holder can adjust the proportions of the policy based on external conditions. If the savings are earning good returns, they can be invaded to pay the premiums instead of injecting more money. If the holder remains

insurable, more of the premium can be applied to insurance to increase the death benefit.

Unlike whole life, the cash value investments grow at a rate which varies monthly. There is usually a minimum rate of return with UL policies, which sometimes can be 4% or more (which seems quite high for a guaranteed rate), which is locked in upon policy issue date. Usually, policies issued during long periods of high interest rates will carry a higher guaranteed rate than those issued during or after a protracted period of low interest rates. These changes to the interest scheme allow the holder to take advantage of rising interest rates. The danger is that falling interest rates may cause premiums to increase or even cause the policy to lapse if interest can no longer pay a major portion of the insurance costs.

For many years, fixed UL products did not have a “guaranteed” death benefit option. Basically, a UL’s death benefit stayed in place as long as the premium was paid. In recent years, UL products have been updated to allow riders that can guarantee a death benefit in a “paid up” manner similar to the 10 and 20 pay policies of a whole life policy. In fact, some UL policies will allow a client to buy a guaranteed lifetime benefit with a single premium.

Unlike whole life policies, the investment returns of UL policies do not issue “dividends” as a way of crediting cash growth in the life policy. Depending on the company used, the dividends in a whole life policy might be higher than the investment returns in a UL policy and they might not. Both fixed UL and whole life are fairly conservative from an investment return standpoint (although those advisors that like whole life policies believe over the long term a quality whole life policy will out perform a fixed UL policy over the same period of time). Universal life insurance policies are generally restricted to safe, low-yielding investments and the most common investments are purchased in the bond markets.

One of the major benefits of a fixed UL life policy is the lower cost of insurance. As stated earlier, whole life is more expensive early in the life of the policy (which limits the amount of cash available to grow in early years). On the other hand, if the dividends in a whole life policy grow to the point that there is the same amount of cash in the life policy as there would be in a UL policy when a client is older, the whole life policy should ultimately out perform the UL policy as an investment due to the fact that a WL policy has lower costs of insurance in the later years.

One other selling point to a fixed UL policy is its flexibility. Without getting into too much detail, it is much easier to make changes to a universal life policy than to a whole life policy. The contractual requirements to make premium payments are less stringent, and it is easier for a client to make changes to the death benefit in a universal life policy.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

There are two major types of Universal Life Insurance: Accumulation and No-Lapse Guarantee products. Let's take a look at each.

Accumulation Universal Life

Products that have strong cash accumulation values generally do not have death benefit guarantees built in. In a UL illustration there will be two value columns, one will show guaranteed values and the other will show current rate values. The accumulation product generally has only strong/positive numbers in the current column. An accumulation product is generally used in supplemental retirement strategies and can provide excellent tax-advantaged retirement income due to favorable loan provisions.

If you have clients that are looking for strong cash buildup with low costs and the potential of tax free wash loans, and long term death benefit guarantees are not the major concern, then this could be the fit.

No-Lapse (Secondary Guarantee) Universal Life (Also known as "no-cash value" UL)

This is a relatively new product and it has taken the industry by storm. It's extremely low cost combined with guarantees of a death benefit at least to age 100, and in some cases, to age 115, is becoming so popular among clients and advisors that it is replacing accumulation UL in many carriers' portfolios.

The other factor that differentiates this product from an accumulation UL product is the cash values. There virtually aren't any. You are essentially purchasing only the death benefit, which is guaranteed never to expire as long as the level premiums are paid.

These products work very well in arbitrage cases where assets are placed into a single premium immediate annuity (SPIA), which in turn pays an annual annuity income stream which is used to purchase the no-cash value life insurance policy. The low cost of the policy allows the most death benefit possible to be purchased. New polices are beginning to allow the premiums to be paid past the age of 100, which will lower costs even more. As with term life insurance, price is not the only factor when choosing a carrier for No-Lapse UL. Be sure to read all policy provisions, and choose only highly rated carriers.

The no-lapse UL is also a good fit for clients who want to pay for a guaranteed death benefit in a single premium or short period of time. If the client pays the appropriate premium, the company will guarantee the death benefit to age 115. Since the client is not going to borrow cash from the policy, this type of policy is ideal for an irrevocable life insurance trust (ILIT), where a policy that is a MEC is not an issue.

If you asked a client who was funding an ILIT if they would like to pay 20% or more for a UL policy that had cash in it or if they would like the lowest costing guaranteed death benefit, what would they say? The client would almost always opt for the least expensive policy that guarantees the death benefit, and that would be the "no cash" value guaranteed death benefit UL.

Universal Life conclusion

Universal Life is a very flexible product that can be used in a wide array of scenarios from estate planning to supplemental retirement planning strategies.

Variable Universal Life

Variable Universal Life (VUL) is a combination of insurance products and mutual funds. Like its cousin, accumulation UL, VUL is very flexible, accumulates cash, and some newer products even offer riders that cover death benefit guarantees.

VUL is a form of whole life insurance that combines some features of universal life insurance, such as premium and death benefit flexibility, with some features of variable life insurance, such as more investment choices. The differences between this arrangement and investing individually in stocks, mutual funds and real estate are the upside of tax advantages and the downside of fees that accompany the insurance policy.

The key selling point to a VUL is that the client can direct the cash invested in the life policy into a variety of investments (typically mutual funds).

Who typically uses VUL? VUL is typically sold by insurance advisors (with security licenses) as an **"investment" or supplemental retirement product**. The sales pitch is that the life policy gets tax free growth and money can be borrowed from the life policy income tax free in retirement. Therefore, the client would be better off with a VUL than a traditional taxable brokerage account.

VULs can work well for clients who are between the ages of 20-50 IF the investments chosen perform well. While there is a nice upside to VUL policies, there is also a significant downside. The client must be willing to take a risk since investment values are not guaranteed. Many times the policy will under perform the illustrated rate, and the client will then surrender the VUL or transfer the cash value to a more stable cash building policy like a UL, EIUI or WL policy.

One of the major problems with VUL policies is the fact that many agents sell them, make their commission, and then do not annually monitor the investments in the VUL. If the investments in the VUL are not managed like a brokerage account, then the likelihood of long term financial success decreases significantly. While properly managed VULs may significantly outperform WL or traditional UL, the success is, in good part, dependant on an insurance/security advisor who monitors the policy.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

One other drawback to a VUL is that the internal fees of the policy are high, and again, if the investment in the VUL does not perform well the client will have the worst of all worlds, i.e. poor investment returns and high internal costs.

One important factor to remember when illustrating VULs is that since the investment values are not guaranteed, once there is a year when the values do not hit the projected values the ledger will be completely off, and the projected values will not reach the values illustrated.

Variable life is a very unique and flexible product for the more aggressive client who is not looking for any guaranteed values. Clients looking to get 10% returns in their life insurance policy with **no investment downside risk** should look at the new Equity Indexed Universal Life policies.

Equity Indexed Universal Life (EIUL)

You rarely meet a client who does not already have some form of life insurance. Years ago, clients purchased traditional whole life policies that were very secure but had poor returns. More recently, clients have become enamored of variable life insurance because the policies buy term insurance (which is inexpensive at a younger age) and invest the balance of the premium payment in the stock market via mutual funds. Many clients seem to like the action in the market whenever they can get it and, therefore, having a life insurance policy that can roll with the market is very appealing.

As many owners of variable life policies have found out, cash values in a variable policy not only go up with the market but they fall with the market as well (see 2000-2003 returns). This prompted creation of a “new” universal life policy, the equity indexed life policy (EIUL). An EIUL is a UL policy that has an annual minimum return guarantee every year but still allows the cash value in the policy to grow at **market rates** every year if the stock market performs well.

How are investment returns calculated in an EIUL?

The portion of the premiums paid into the product which are not allocated to insurance costs (M&E costs) are used to purchase options in a stock index (typically the S&P 500 index). This allows the client to participate in a portion of that index’s growth while still maintaining a minimum interest rate guarantee. The participation in an index such as the S&P 500 typically outperforms traditional returns in a whole life or universal policy. For example, from 1994-2004, the S&P 500 still averaged 12.1% (even though the stock market had a “crash from 2000-2003).

In order for an insurance company to be profitable with an EIUL policy, there are “caps” on the upside growth of the measuring index being credited to the cash value. The cap can change every year with some products, and every 2-5 years with other products. If the insurance company is not profitable over a

period of time with the EIUL, it can lower the caps to the lowest allowed by contract to make the product profitable over the long term.

The other way an insurance company can make sure an EIUL stays profitable is to change the participation rate. The participation rate determines how much money in the cash account of the life policy will grow with the index. For example, if the participation rate is 100%, all of the cash value in the life policy will grow with the measuring index. If the participation rate is 80%, 80% of the cash in the policy will grow with the measuring index and 20% of the cash will have no growth credited during the investment period (which will typically vary between 1-5 years).

Here is a good way for you to explain this concept to your clients.

Assume a client pays a $108,000 premium to an EIUL where $100,000 was credited to the "growth" account and the policy has a 100% participation rate in the measuring index.

If the measuring index is the S&P 500 and the current cap is 10% and the S&P 500 returns 15%, the cash in a client's policy will be credited at 10%, not 15%.

If the measuring index goes negative, the EIUL guarantees that the cash value will still have positive growth (usually 1-2%). If negative returns happen too many years in any period, the life insurance company will not be nearly as profitable as anticipated and the company will likely lower the caps.

In most EIUL policies the client has the option of taking all or part of the cash value out of the indexed account and putting it into a fixed account (which would give returns similar to a fixed UL product). The fixed account returns are driven, for the most part, by the bond markets. As bond yields fluctuate, so too will the returns of the fixed account in an EIUL.

The caps in the EIUL are basically driven by the option prices on the index used in the policy. Therefore, if the S&P 500 is used as the measuring index, and option costs on the S&P 500 rise, typically the caps on the EIUL will be lowered to keep the overall costs of the product in line so the insurance company can remain profitable.

Here's an example to illustrate how switching to the "new" EIUL policy can save a client significant money.

Doctor Smith in January of 1999 had a variable life insurance policy with a $2,000,000 death benefit and a cash value of $250,000. Because he had his cash value invested in an XYZ aggressive growth fund (which we will assume averaged negative eighteen percent (–18%) from 2000-2001), today his cash value in his variable life policy is $168,100. Needless to say, Dr. Smith is not happy.

If Dr. Smith had the "new" EILIP, he today would have had plus 2% credited towards growth in his policy; and, therefore, his cash value would be $260,100.

For those clients using a traditional whole life policy, an example works as well to illustrate how much money could be lost by not using the "new" indexed life insurance policy.

If Dr. Smith bought a whole life policy, the investment return inside the whole life policy could be less than 5% a year (depending on the dividends in the life policy). If he has $250,000 in cash value inside a whole life policy today making 5% in growth every year, he will have $319,070 in five years (these are approximate numbers for illustration purposes). If Dr. Smith used the "new" indexed life insurance policy and the S&P 500 Index had returns of 8%, he would have $367,332 or about $48,262 more in cash value just over that five-year period by using the "new" EIUL policy.

Pros and Cons of the "new" EIUL policy:

Cons –

1) If the market averages much more than the cap rates for the time the client has the EIUL policy, the client would be better off with a variable policy (not very likely).

2) If the market averages less than 5-6% in annual returns over the time, the client would be better off with a conservative whole life policy (not very likely).

Pros –

3) There is a minimum guaranteed return every year (1-2% depending on the company)

4) The policy does let the owner partake in the upswings in the market, up to 17% with some companies at the time of this writing (**therefore the policy has better upside potential than a traditional universal life or whole life policy**).

5) Mortality costs (costs of insurance) are much lower in the later years than a variable life insurance policy.

6) Flexibility. Unlike typical whole life policies, the "new" EIUL policy is very flexible so the owner can choose when and how much premium is to be paid each year.

Conclusion

If your clients like the possibility of getting upwards of 10-17% return on the cash value in their life insurance policy every year and would like to avoid the

stock market's negative years with a 1-2% minimum guarantee, then they should be shown the "new" EIUL policy. Also, if your clients are nearing age 50 and have a variable life insurance policy, they should seriously consider changing to the an EIUL policy to protect the principal cash value in their policy and to lower the costs of insurance inside the product.

Survivorship or "2nd-to-die" Life Insurance

This type of coverage is generally offered either as Universal Life or Whole Life plan and pays a death benefit when the second of two insured individuals, usually a husband and wife, dies. It has become extremely popular with wealthy individuals since the mid-1980's as a method of discounting their inevitable future estate tax liabilities. Ever since Congress instituted the unlimited marital deduction in 1981, most individuals have taken advantage of their ability to arrange their affairs in a manner such that they delay the payment of any estate taxes until the second spouse's death. These "2nd-to-die" contracts allow the insurance company to delay the payment of the death benefit until the second spouse's death, thereby creating the cash needed to pay the taxes exactly when needed.

This coverage is widely used because it is generally much less expensive than individual coverage on either spouse. If the ultimate goal of a married couple is to fund a death benefit to pay estate taxes (or simply to pass wealth to the heirs), a 2nd-to-die policy is the least expensive way. In order to find the client the lowest possible premium, the client should look at a "no-cash value" guaranteed death benefit 2nd-to-die UL policy (which should be owned inside an ILIT).

Policy Riders

All the policies we have discussed have policy riders available. These vary from product to product and from carrier to carrier. These are the most common.

-<u>Waiver of Premium</u>. This rider will waive all premium payments during a period of disability, after a stated waiting period. This rider is very important and can make sure a supplemental retirement plan will self complete if a disability does happen.

-<u>Guarantee Purchase Option</u>. This rider allows the client to purchase a stated amount of coverage at a future date without proving insurability. This could become extremely important in the event a client becomes seriously ill.

-<u>Long Term Care Rider</u>. This rider is very attractive. It allows the client to purchase coverage that will help cover the cost of a nursing home or assisted living facility in the event the client needs long term care. These costs can be crippling and financially devastating without some form of coverage.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)

-Estate Preservation Rider. This rider is very useful in Estate Planning, and is available from a limited number of carriers. It allows the client to have a higher death benefit in the first four years, which can help offset the event of an estate tax look back during early policy years.

-Return of Premium Rider. Unlike the return of premium on term life, this adds the premiums paid into the contract to death benefit values. Some contracts even guarantee this additional value.

Underwriting

The last issue to discuss is potentially the most critical factor in insurance, i.e. underwriting (**especially when pricing the life insurance premium**). All the features and design of products don't mean much if you cannot get the underwriting offer that the client needs to make a plan work. No insurability, no coverage. When dealing with all cases underwriting is important, but when dealing with larger cases it becomes critical. Healthy rate classes range from super preferred to sub-standard. There are many terms that are used in underwriting that you should know when dealing with your general agency. Let's cover them.

-Table Ratings. In the event of a medical condition a client will receive a table rating or increased cost of insurance. The ratings are given as a letter or number rating, and range from 1-12 or A-L. Some carriers may even go to a Table16. The higher the number or letter, the higher the cost of insurance.

-Flat extra ratings. This rating is generally given for rating on avocation or hobbies. For example scuba diving may receive a permanent flat extra rating of $2.50 per thousand. There are also temporary ratings which may be assessed for certain medical conditions. These ratings can greatly increase the total cost of insurance.

-Table Shaving. Several carriers offer table shaving programs where, if the client can be underwritten, lets say, as a table 4 they will be shaved to a standard rating. Some will shave from a table 2 to standard, Consult with your General agency for more.

-Retention Limits. When dealing with larger death benefit cases this is very important factor. Essentially it is the amount of coverage a carrier will retain in-house before entering into the reinsurance market (we will cover reinsurance shortly). This varies from carrier to carrier and can range from zero to $30 Million. These limits can and do change so check before working on a large death benefit case.

-Auto Bind. Auto Bind is the amount a carrier can automatically cover a proposed insured for, over and above their in-house retention limits, without needing to go to their reinsurance partners for approval. The carrier's

reinsurance treaties will determine how much this amount is. Much like retention limits, this amount depends on the carrier being used. It can range from zero to sixty million.

- Reinsurance. Each carrier has reinsurance treaties to help offset the risk they place on their own books. Reinsurance is generally used on cases where the client is in poor health, and the carrier is unwilling to assume the entire risk of insuring the client, the carrier will then “shop” the case. Shopping the case means the carrier is entering the reinsurance market to shop for an offer to obtain coverage on the client. Another reason reinsurance is used is for large death benefit cases where the death benefit is above the carriers retention or auto-bind limits.

- Jumbo Limit. Jumbo limits are another feature that vary between carriers. This limit again is only used in large death benefit cases. It takes into account not only the amount of insurance being applied for, but also the amount the client currently has in place. This amount, in large case scenarios, determines whether the case needs to go to reinsurance to bind coverage.

- Cover Letter. The cover letter can become the most important factor in the underwriting of a case. It provides the underwriter with a synopsis of the client who is applying for insurance coverage, and will list several important factors such as: Lifestyle, health conditions, prescriptions, annual income and net worth, amount of insurance being applied for, date of birth, and amount of coverage currently in-force. The cover letter can be the reason that a client does, or for that matter, does not obtain the insurance coverage applied for. If you are unsure on designing or writing a cover letter, or feel uncomfortable writing the cover letter, consult the general agency you are working with (or if you are not a licensed agent, find a quality agent who can help with the cover letter)..

Conclusion on life insurance

While many clients think that anyone can get a life insurance license and therefore anyone can give good advice about life insurance policies, you now know that there are many variables and nuances to life insurance policies that must be known in order to give the best advice to clients.

Most non-insurance advisors do not try to give advice to clients on the issue of life insurance except to tell the client to purchase a policy with the lowest possible costs with a highly rated carrier. With the information learned in this education module, non-insurance advisors should be able to talk intelligently with a client’s insurance agent and lend value when helping the client choose the right type of life insurance policy with the proper terms and riders.

Copyright 2005, The Wealth Preservation Institute (www.thewpi.org)