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A 12 Hour Continuing Education Course:

"INTEREST SENSITIVE INSURANCE PRODUCTS: THEIR MARKETING AND TAX ADVANTAGES"

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“INTEREST SENSITIVE INSURANCE PRODUCTS: THEIR MARKETING AND TAX ADVANTAGES"

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An Historical Perspective and Economics Discussion

Introduction

Although life insurance has been in existence in America since the 1800's, it was not until very recently that the consumer had such a banquet of choice and opportunity available to meet virtually every financial need. The economics and tax law of the 1930's through the mid 1970's dictated the manner in which insurance products were available to consumers just as they play the key role in product offerings today.

The early forms of maritime risk transfer in Europe during the 16th century allowed ship and cargo owners to be indemnified in the event they lost their assets due to the hazards of ocean travel. This would give way to applying such concepts to human life. In the mid-1700's a European mathematician conceived the first mortality table, a device through which predicting the span of human life became a more definite and measurable science.

As the Industrial Revolution spread from Europe to America in the early 19th century, with it came the concept of Industrial Life insurance. Small face amount policies, typically from $50 to a few hundred dollars, were marketed to hard-working factory laborers whose life spans were not particularly generous. A 'debit' agent would come to the worker's home every week to collect meager premiums amounting to a only few pennies. This premium collection would help to fund and build multi-national corporations which today boast tens and hundreds of billions of asset dollars. Familiar companies like, Prudential, Metropolitan, New York Life, etc., shared these somewhat humble beginnings.

As America grew, so did her appetite for inexpensive immigrant labor. Millions of hard working new citizens looked for the streets that were fabled to be paved with gold. During this period, the nation's insurance companies prospered. Tens of millions in premium dollars were placed with insurance companies who, in turn, needed places to invest the money. Investment enabled them to meet their obligations to pay death benefits, overhead expenses and, of course, reap profits.

Obtaining premium dollars from the citizenry meant competing with other 'intermediaries' in society, chief among them the banking and savings and loan industry and the secondary (stock markets) marketplaces. **Intermediaries are institutions in society soliciting funds from individuals and business in exchange for paying a return for the use of the money over time.** The goal of the intermediary is to earn more money than they are required to pay for using it. The next section examines the economic recent past of America and the effect it had on **three main intermediaries: insurance companies, banks and savings and loans and the stock and bond marketplaces.**

The Economics of 1925-1984 and Their Effect on Financial Intermediaries.

The 1920's in America were whimsically called "The Roaring Twenties" for a reason. Exciting new inventions, fresh investment opportunities, Prohibition and the rise of organized criminal activity combined at the same point in time to create an atmosphere of economic invincibility. A member of the general public could buy $1 worth of ownership in a major corporation with a scant ten cent investment while the rest was furnished the friendly brokerage house that was eagerly willing to finance the purchase. People became obsessed with the euphoria created by enormous paper profits as they witnessed the almost miraculous rise of their investment portfolio.

Then that famous day in October 1929 forced everyone back into the real world: the stock market signaled an economic collapse heard around the world. On a simplistic basis, the stock market crashed because everyone was willing to sell stock but buyers were as scarce as dollars. At the time, the federal government decided to strangle the nation's money supply in a futile attempt to quell the financial panic.

Brokerage houses were placed in a perilous position: they had lent most of the money to the public for the purchase of securities and now the value of those investments had shrunk to the point where it was the brokerage house, and not the stockholder, who was actually losing the money. The brokerage house contacted clients and told them that they must bring in more dollars to cover the mounting losses. But from where could these clients get the funds? Many would visit their bank or savings and loan.

The long lines found near banks and savings and loans told the story. Everyone had the same idea of withdrawing their savings as the solution to floating through tough times. The only problem: the savings institutions had very little money on hand. Then, as now, depositor money is lent to customers who borrow at a higher rate. Deposited money is not placed in a vault where it mysteriously multiplies as it waits to be claimed by its owner.

The insurance industry was able to handle the financial crises in a much more successful manner. Since their main function is to satisfy death benefits as they are legitimately claimed, short term cash reserves were readily available to meet this purpose. Since the vast majority of the industry's assets were invested in long term and illiquid vehicles, insurance companies experienced the same severe cash shortages felt by their financial counterparts. Policyholders requesting cash surrenders or policy loans were refused even though their contract said they could borrow. Although policyholders found their normals rights suspended, the end result justified the means: policyholders cash values turned out to be 99.71% safe!

As the entire world struggled through the deep depression of the 1930's, the next decade would bring turmoil of a different nature. World War II helped to end the economic hard times but at a tremendous cost to human life. America was forced to utilize all of her resources for mere survival. All healthy adult males were expected to bear arms against enemies. Factories and industry had to cease production of goods for a peacetime population and retool to produce the weapons of war.

The resource of money was much sought after by the government. Everyone from Mickey Mouse to Cary Grant urged Americans to buy War Bonds and underwrite the expense. If you were not investing your money patriotically in War Bonds, your options were quite limited. An example of a safe corporate bond offering was 2 1/2% for 40 years! Invest $1,000 and receive $25 per year and, in only 40 years, your $1,000 is returned. By the standards of today this sounds completely inadequate, but in 1942 it seemed like a wise investment.

As the war concluded in 1945, GI's returned home to hero's welcomes and life returned to a more normal state. However, there was one huge problem. It would take a year or two for business and industry to adjust operationally back to serving peacetime needs. Auto plants that had been producing jeeps and tanks now had to resume the manufacture of family vehicles. Other durable goods like refrigerators and washing machines were in short supply but in great demand. Prices rose dramatically as inflation was fueled by too much money chasing too few goods. The rate of inflation for 1946 and 1947 were a staggering 10% and 12%, respectively.

The basic insurance contracts available in post World War II America were offerings of endowment, whole life and (somewhat grudgingly) term insurance. While endowment contracts were the darlings of the fifties and sixties, whole life began building in popularity in the 1960's and term insurance gained favor by the late 1970's. To properly understand this product evolution that lead to today's product revolution, a discussion of these contracts and their popularity is necessary.

The boom times following World War II found Americans with a new prosperity but still burdened with the pessimism of the recent past. **Endowment Life insurance was tailor made for success in this time period for several reasons.** The main competitions for endowment life in the 1950's were bank and savings and loan passbook accounts. Stock purchases for the individual were not a highly sought after alternative in view of the fact that adults of the day had been children of the depression era stock market crash.

Endowment Plans provide a level death benefit, but their **main focus is on cash accumulation**. The premium charge is significantly higher than for comparable amounts of protection under a whole life plan, but the policy matures (pays the full face amount) at a specified future point in time. Because they provided guaranteed future amounts of cash, endowments were primarily marketed as either retirement enhancements or fund builders for educational purposes.

The main reasons for their popularity were **rate of return, tax advantages and the fact that the Americans of that era were hearty savers.** Imagine yourself as head of a 1950's family. You are concerned about saving money for your children's education or your own retirement. Your basic choices are a bank account or an endowment policy. The bank is paying 3.25% interest which is income taxable. On the other hand, an **endowment is** paying 3.25% with **tax deferred cash accumulation until maturity. If you die** prematurely as the insured in an endowment contract **your family receives a guaranteed amount that is free from income taxation.** Furthermore, if you become totally and permanently disabled the insurance company will continue to pay your premiums on your behalf and complete the plan on schedule. On the other hand, your bank account value stops when you die and if you are disabled, your ability to continue making deposits will stop as well. Which method of saving would you choose?

The 1960's saw interest rates and unemployment rise over levels of the Fifties. Also making itself felt was inflationary pressure unknown since the end of the WW II. Although endowment plans would still be popular into the 1970's, whole life insurance was being purchased in record amounts.

Whole life products have traditionally been distinguished from other insurance products because **of fixed premium, level face or death benefit and coverage that lasts for an insured's entire life.** Premium cost is fixed due to mortality rates, returns on invested premiums and overhead costs.

Whole life products place much greater emphasis on the protection element and less on savings when compared to an endowment. However, the savings feature, or "cash value" of whole life, was still a very important consideration. Being able to borrow against cash values at low guaranteed rates in an emergency was a strong selling point.

Whole life is a long range product. It should not be purchased with the idea of retention for only five or ten years. Over a very long time period (20, 30 or more years) it will serve well and predictably. **The drawback: a comparatively low and conservative rate of return.** Most whole life plans written in the 1950's to 1970's provided a modest built-in return of between 3% to 4%. Again, they were geared for protection and not accumulation. Most people owned a whole life plan and not much fuss was raised until the hyper-inflation of the late 1970's and early 1980's. When taken in context, whole life was a highly competitive financial product until the day interest rates went haywire.

As America began to switch from a manufacturing to a service based economy the inflation, unemployment and interest rates increased dramatically. Short term returns on certificate of deposits hit 11, 12, 14 and even 16%! The built-in whole life insurance cash value returns of around 4% looked embarrassingly meager. A new battle cry could be heard throughout the land: **"BUY TERM AND INVEST THE DIFFERENCE".** Although the economic factors leading to this volatile period are varied and complex, their effect would profoundly change the way the insurance companies did business.
The replacement of whole life with term insurance

began to take root. Those who were not cashing in whole life were taking out maximum cash loans against value. **The strategy was simple: borrow cash value at 5% or 6%, invest it in a 15% CD and pay the interest on the loan while walking away with a handsome profit after paying income taxes on the CD income**. Major insurance companies became uneasy as they found it necessary to sell bonds and stocks in order to have adequate cash flow. Not since the great depression had such a cash crisis faced these corporate giants.

In more steady economic periods it is usual for about 2%-3% of the asset base of a company to be requested by policyowners in the form of loans and surrenders. By the early 1980's, from 12%-15% was demanded. Although this was a staggering percentage, perhaps even more remarkable was the fact that is was not significantly higher.

Insurance giants could have invoked the "delay clause", a state insurance law allowing companies to make policyholder wait up to six months for cash surrenders or loans in times of financial uncertainty. The Insurance industry chose not to invoke the delay clause. Why? Their concern with future reputation outweighed current short term losses. Insurance company officials probably voiced more than one plea to a Higher Power for interest rate relief.

In the meantime, the only other option available was to create and introduce new insurance products capable of competing in widely fluctuating interest rate markets. These new products would have to be designed in such a manner that policyowners would not have any incentive to remove cash values and place them elsewhere on either a temporary or permanent basis when interest rates rise quickly. **Term insurance** became the protection of choice. Term life is **very low cost insurance.** The premium increases with age, the death benefit can be level, decreasing or temporarily increasing and coverage is considered temporary and not for an entire life. **There is no cash value or savings element, therefore the purchase is one of insurance only.** Again, there is no mystery about the strategy suggested and employed:

- *A MALE AGE 30 COULD BUY $100,000 WHOLE LIFE FOR $1200 ANNUALLY. THE SAME AMOUNT OF TERM PROTECTION WOULD COST $200 PER YEAR. THE STRATEGY WAS TO BUY THE TERM AT $200 AND PUT THE $1000 OF SAVED PREMIUMS IN A HIGH INTEREST RATE CD.*

IN JUST A FEW YEARS, THE INTEREST FROM THE CD WILL PAY THE COST FOR TERM INSURANCE. WHEN YOU ARE 60 OR 65 YOUR CD WILL BE WORTH SO MUCH MONEY, YOU WON'T NEED ANY MORE LIFE INSURANCE AND INCREASED INSURANCE COST AT AN OLDER AGE IS NO LONGER A CONCERN.

Taken at face value in 1979-1983, who could argue? But things were about to change dramatically. First, inflation was being brought under control. Second, double digit rates of return were no longer achievable on a steady and conservative basis. Third, insurance companies were about to fight back strongly with competitive products that were interest sensitive.
Before a discussion of specific interest sensitive products can begin, a brief discussion of several key concepts is necessary. Grasping the fundamentals of

life insurance is not possible without understanding future and present value concepts and how they are affected by variable and fixed rates of return.

Fixed vs. Variable Rates

The nature of risk is closely linked to whether a rate of return is fixed or variable. In the world of investment the general rule is: **"the higher the return, the greater the risk; lower the return, and lessen the risk."** Any investment decision primarily rests upon the extent to which the investor is willing to accept the potential loss of (original) capital.

For example, the most conservative yet liquid investment is the United States T-Bill. Correspondingly, the return is fixed at rates considered conservative for the investment environment in which they are offered. The central idea is safety of capital - you will not lose your investment; therefore your return is average (and taxable) to reflect the virtual absence of risk. This is a **fixed (known)** rate of return investment.

An important question needs to be asked: **"How safe is safe?"** An investor can not get safer than government securities, true enough. However, **is the government's promise to pay absolutely failsafe?** You decide. The government backs its promise to pay with what is termed "the full faith and credit of the United States Government." Simply put this means two things. First, the government can increase taxes to raise revenues and second, as long as people believe in their government, its currency has value.

But **what if the unthinkable happened?** Suppose one fine morning a substantial number of Americans no longer had confidence in either the government or the money it prints. Would you accept dollar bills in exchange for goods and services or would you prefer something more substantial or useful (like food or clothing)?

Although the United States government establishes fiscal and monetary policy for the fifty states and several territories comprising our great nation, other powerful world economies profoundly affect the values of our own goods and services. The United States, although still a major economic force on the world stage, no longer is able to exert the control and will it once could.

In addition to government securities, many Americans select banks and savings and loans as the institution of choice for their money. The public feels secure with this choice because of FDIC and FSLIC insurance on deposits up to $100,000. This enormous confidence stems from consumer faith in the government which backs the deposits. **With what does the government back these trillions of dollars?** With full faith and credit, of course.

Therefore the same important questions posed earlier needs reiteration: "How safe is safe?" Recall the Savings and Loan fiasco of the late 1980's, through which approximately 200 to 300 billion (depending upon whom you believe) dollars were lost. These billions are now part of the national debt, a legacy which shall make the next several tax paying generations liable for repayment. Could the entire banking system again collapse? It has several times before and likely will again someday.

If we cross the street from fixed and walk over to the variable side, investments such as buying and selling the stock of publicly traded corporations is considered somewhat risky and unpredictable. A stock can both appreciate in value and pay a rate of return via a dividend. This opportunity for high return must be tempered with a considerable vulnerability for loss of capital.

While income may be paid on the invested capital, the value of the stock may decrease markedly or even cease to exist. Such risk and unpredictability illustrates the concept of **variable (unknown)** rates of return.

Whether or not a person will put their hard earned dollars in fixed or variable return opportunities is dependent upon the investment philosophy of the individual. The very conservative person will seek to preserve existing capital at all cost, therefore rate of return is not the main consideration. Conversely, the risk taker is very willing to accept the potential loss of some or all capital in exchange for a potentially dynamic return.

A good question to ask any prospect is: "Are you more concerned with <u>the return on</u> your capital or <u>the return of</u> your capital?

Think of your accumulated savings as a pile of money. The rate at which this pile grows depends upon the capital you invested and rate of return paid to you on that capital amount. Alter either the amount of capital or interest payment rate, or the total size of the pile of money accumulated changes to reflect the alteration. We know that rates of returns can be variable or fixed, but what about our principal amount? What can occur to reduce the principal amount before or during investment? The smaller our pile, the less is our chance to accumulate a comfortable amount of money for the future.

There are four basic threats to principal:

- *A risky investment that turns sour and reduces the amount we have to invest. (Have you ever made an investment you later regretted? If you are over forty years old your answer is probably a resounding "yes!".)*

- O*ur friendly federal and state partners who tax significant portions of most of the good fortune we may enjoy.*

- *Inflation in even modest amounts seriously erodes the purchasing power of our pile of money over time.*

- *Finally, dipping into our principal savings in the event of individual economic emergency will erode accumulated principal amounts.*

If an individual makes a poor investment, common sense dictates that the younger the age at which it occurs, the better. Making a serious error in investment judgment at age 50, 55 60 will result in "golden years" turned to the rust of economic disaster.

Paying taxes is a necessary evil for most people but a sizeable majority pay more than is required of them. By placing significant portions of principal in safe and highly accessible (also called “liquid”) investments, income taxes become due and payable each year.

Tax-free and tax-deferred savings vehicles are often avoided because most of them require long term dedication to saving without easy or painless access to funds.

Even low inflationary pressures resulting from 4 to 5 percent will take a heavy toll on the future purchasing power of any investment. By placing money in a lower and safe return investment in which after tax returns are then offset by the current inflation rate, the investor has historically finished with less purchasing power than he had at the time the investment was made.

Combine all three considerations above with the fact that America has not been a nation of dedicated long term savers for the past couple of decades and you have a recipe for future financial instability. People will save money for short periods of time only to yield to the temptation to spend. The "saving to spend" syndrome, as it has been called, establishes a hard to break habit which results in current consumption of goods at the expense of long range financial security.

The insurance industry today offers interest sensitive products compared with traditional life products of the past. Current plans enable consumers to achieve rates of return on policy cash values which fluctuate with the actual economic environment. In addition, these cash values are allowed to accumulated on a tax-deferred basis. Since life insurance contracts which are guaranteed by insurance companies are considered very safe, the consumer is able to match the returns offered by bank accounts and government securities without the burden of current income taxation. Reduced current taxation on unearned income means a better chance to keep pace with, or even defeat, inflation. This enables the consumer to have greater purchasing power.

This leads to the last discussion point prior to a review of individual products. Achieving an understanding of the future and present value of money is essential for anyone associated with insurance or any financial services related field.

TABLE 1: The Investment Pyramid

● Arts
Metals, Gems,
Options, Venture Capital
Δ Growth Mutual Funds
Investments in Real Estate Projects
■ Balanced Funds, Conservative Equities
Municipal Bond Funds, Utilities, U.S. Bonds
❖ Life insurance, CD Savings, T-Bills, Money Market
● = Speculative (Very High Risk)
Δ= Growth (Moderate Risk)
■=Secure (Low Risk)
❖=Liquid (Very Low Risk)

It is suggested that an individual's investment program should have the strong foundation of a pyramid with riskier investments comprising lesser percentages as risk increases.

Future and Present Value Concepts

These concepts are often made to appear much more difficult than necessary. There is nothing mystical about mathematics or time and both underlie future and present value. Future and present value is little more than the **value of an amount at specified points in time:** either looking ahead to a designated point in time to see **how much is needed at some distant point (future value)**; or taking **the real value of an amount known today** (**present value**).

A familiar example of these concepts is the use of an annuity in paying the winner of any state's lottery. When a Lotto winner hits a 1 million dollar payoff, does he really win a million dollars? Yes, eventually. For instance, some states pay such a prize over 20 years at $50,000 per year. However, in waiting so long to collect the prize in small pieces, the value of that money diminishes because of inflation (we won't even mention the income taxes that are paid along the way). As a matter of fact, the State buys the $1,000,000 payoff over 20 years for approximately $425,000 today. The state purchases an annuity from an insurance company and names the winner as the annuitant.

Bear in mind that given the existence of inflation, or increases in cost over time, one dollar today will not be worth one dollar tomorrow (refer to the "Consumer Price Index" in Table 2 located on the next page for the impact of inflation on the value of a U.S. dollar since 1967). By the 1990's it takes nearly $4.00 to purchase the same goods that $1.00 could purchase in the late 1960's. In this sense $1 was worth $1 in the late sixties (its present value at that time); but in terms of the 1990's, it would be worth 25 cents (its future value relative to the late 60's).

Discounting is the process by which the present value of a dollar is payable at a future specified time. Again, the notion that today's dollar is worth more than the dollar of tomorrow. Consider the relationship between preservation of capital, inflation, and taxation of income. Earning returns that keep pace with inflation, let alone result in actual growth, becomes a formidable task.

TABLE 2

CONSUMER PRICE INDEX*

In 1967 the United States government decided to measure the change in the price of selected goods and services and compare them from year to year. This "urban" purchasing pattern became the statistical measurement for the U.S. economy inflation rate.

PURCHASING POWER OF ONE DOLLAR

YEAR	**INDEX**	**VERSUS 1967**
1967	100	$ 1.00
1970	116	$ 0.86
1975	161	$ 0.62
1980	246	$ 0.41
1990	386	$ 0.26
1995	449	$ 0.23

* By late 1996 U.S. the government decided to shift away from using the Consumer Price Index to measure inflation. It was felt it no longer appropriately reflected "true" inflation percentages.

The effect of inflation on the purchase of life insurance is a fundamental relationship. Even if a policyholder's needs do not change over time, more insurance coverage becomes necessary simply because of the erosion of purchasing power due to increasing costs. Applying the values shown in **The Consumer Price Index of 1967** indicates that a $100,000 face amount of life insurance purchased in 1967 has the purchasing power in 1990 of only $26,000! Therefore, coverage purchased in the past can no longer do the job it was intended to do in the present. Yet there are great numbers of insureds who purchase life insurance and rarely update face amount. This is the main reason studies show that the vast majority of Americans do not own adequate amounts of life insurance.

Refer to the lottery example given earlier. The first $50,000 installment, after 33% taxes, has the purchasing power of $33,500. Although no recipient of such a quick and unearned sum would likely complain, this same amount will be paid annually for 19 more years. However, the purchasing power of this $33,500 will decline each and every year if the economy experiences inflation. For example, an inflation rate of 5% each year would mean that the 20th, or final installment, will have the after tax purchasing power of less than $ 12,000 in present (today) value. Without dedicated and planned investment, the lottery winner could find himself in dire economic straits despite this original good fortune. Since most Americans will not win a lottery prize, saving for the future is even more difficult because of lack of capital. Whatever capital is invested must earn an after tax rate of return which will retain current purchasing power levels. The Consumer Price Index of 1967 indicates that in order for the 1967 investor to retain purchasing power, he had to invest $1 so that in 1990 it was worth $3.86 after all income taxes were paid!

The average rate of return after taxes for fixed and conservative investment (i.e. T-Bills and bank CD's) for this period shows that only $2.73 would have been available before income taxes were paid! This means the typical investor would have fared better spending all their money in 1967 when it was worth the most in terms of its ability to purchase goods and services.

What if the 1967 investor placed this money in tax deferred devices, such as an annuity? A substantial level of purchasing power would have been retained. Where do many Americans still place their money for investment? A large percentage of it goes into the very devices which are conservative in nature and currently income taxable. Many trillions of dollar are currently invested in bank certificate of deposits and passbook savings accounts.

The reasons investors place money in areas where they will be economically harmed over the long run are sad but predictable. Americans do not seem fond of much risk and taking the time to investigate and learn about investment alternatives also does not seem very popular.

It is human nature to avoid the unknown in favor of predictability even when the predictable carries with it known disadvantages. Doing what is easy is preferred to doing what is right. Is it any wonder with today's fast paced economic conditions, the vast array of investment opportunities and tax reform, that the average American would be confused and just play it safely: put the money in the bank, get low returns and pay taxes on the income?

Earlier it was mentioned that there is a banquet of choice and opportunity to meet every financial need, but what is the good if you don't know there's a party going on? More likely, most people are afraid of concepts with which they are unfamiliar and for the most part, they just do not R.S.V.P. The insurance professional is in the unique position to help the American consuming and investing public to make better and more rewarding financial decisions. The interest sensitive insurance products available on the market today are highly competitive with low and higher risk financial products, yet many consumers have not availed themselves of their benefit.

The focus of this course is placed primarily on five products. Three of the five are relative newcomers while the other two, annuity and single premium whole life have existed for decades. Each has characteristics making it unique in serving some market segments better than others. All have one thing in common: preferred tax treatment.

Interest Sensitive Insurance Products:
Their Structure and Need Satisfaction
The products to be analyzed include

- **Universal Life**
- **Interest Sensitive Whole Life**
- **Variable Life**
- **Single Premium Whole Life**
- **Annuity.**

These products cumulatively can serve both the protection and cash accumulation needs of virtually all market groups. From young singles and married to middle-aged to retired people. Each market segment has particular needs and objectives. The young family needs protection while the middle aged couple is concerned with educating teenage children and, at the same time, is eyeing a retirement age that no longer seems as distant as it once did.

Universal Life

No insurance product has ever had more publicity (both good and bad), discussion and fast market growth (and decline) than has Universal Life (UL). Never before in the history of the insurance industry has one product caused such analysis, debate and economic impact. Since its market debut in 1979 by a single small insurance company, Universal Life became the product market share leader among new policies sold in the mid 1980's. Currently, over five hundred life insurance companies offered a universal contract.

Industry market studies indicate that from a peak market share of more than 40% in 1985, Universal Life's popularity has decreased to the 20%-25% range in sales. Many companies that had been initially enthralled with UL began cutting back on its sale as it became viewed by some firms as a severe threat to future profitability.

When it was first introduced, Universal Life was designed as a low commission (40-50%) contract which promised high volume sales because of its consumer oriented design. As competition increased, so to did the commissions offered by insurance companies to attract a sales force. Some product providers cannibalized the concept to such an extent that they began to lose money, forcing them to downplay the marketing and sale of universal life insurance.

It was not until 1984 that the United States Congress redefined life insurance and the Universal Life policy fully qualified. For that reason, many insurance companies held back from offering a universal type product until 1984 even though the concept had been launched 5 years earlier. In general, **Universal Life is a permanent insurance product that allows the policyowner an opportunity for making flexible (varying) premium payments.** Universal Life is also known as "Flexible or Adjustable Premium Whole Life".

Confusion does exist as to the precise nature of Universal Life. Although it is considered by insurance insiders as whole life because it allows for the accumulation of cash value to equal an identified endowment point (age 95), the IRS recognizes UL as term insurance by its definition.

As we shall see, UL exhibits signs of being both term and permanent. The cost of UL, however, is decidedly based on the term insurance concept.

The most important distinction of Universal Life from traditional life insurance is the flexible nature of its premium payments compared to the definite fixed amounts required by traditional whole life. As long as the policyowner pays enough premium to take care of all policy cost, the UL contract will not lapse. To the extent more premium is paid than is necessary for cost, excess money goes to **the policy account** where it **earns a fluctuating (interest sensitive) rate of return.** The maximum premium which can be paid is dictated by current IRS insurance definitions. If the policyowner chooses to skip normal premium payments, the insurance company simply deducts required charges from the existing funds in the policy account.

Another major difference between Whole Life and UL is that the UL policy account is the insured's money, while the cash value of Whole Life belongs to the insurance company until the insured's death, endowment of the policy or cash surrender occurs. This means the UL policyholder may access cash values by simply requesting the money and no interest will be assessed by the company on any funds which are withdrawn, or partially surrendered. Furthermore, the charges inherent within the UL policy are supposed to be **"transparent"** while Whole LIFE "bundles" the cost with conservatively projected returns. Again, the **original intent of UL was for anyone to plainly see where every penny of premium dollar went.** However, the actually marketing evolution of UL by many companies has resulting in far greater cost bundling than was originally intended.

Universal Life Policy Cost and Charges

Current Mortality Charges. Mortality tables are used to determine the rate at which people, in a given population, will die. Everyone, for insurance purposes, is dead at age 100 for traditional Whole Life purposes and at age 95 for Universal Life. Currently, all companies may utilize the 1980 CSO (Commissioner's Standard Ordinary) mortality table. Tables have been updated historically about every 20 years since 1940 and the trend has always been toward lower and lower insurance rates due to the increasing longevity among Americans.

Mortality rates are subject to change but they are usually guaranteed on the basis of the current CSO mortality table, which is a very conservative basis. Companies **charge for mortality according to "current"** mortality factors (as recent as within the last year) which are far less expensive than guaranteed costs as established in the mortality table. Although mortality is the main basis of cost for UL contracts, there are other factors as well. A company charges on a current cost basis to be competitive but, like most term insurance contracts, a table of maximum guaranteed cost is placed in the UL contract. A table of maximum guaranteed cost enables an insurance company to market term insurance at competitive current rates while allowing for the possibility of substantial increase (to a stated maximum amount as defined in the table) should the need arise due to rapidly increased mortality rates.

<u>Load Variables (and other charges)</u>. Universal Life is supposedly transparent, meaning a policyholder can view the internal cost workings of the policy itself. Illustrations of Universal Life can demonstrate the interaction of cost per thousand, premium, premium taxes, monthly charges, loads, surrender charges, rider cost and policy values. Therefore, this transparency results is the separation of cash value from charges for insurance amounts and policy administration.

A closer look at charges reveals that Universal Life policies are "loaded" either at the front end, back end or at both ends. A **front end load** places a charge at the beginning of the contract. The main disadvantage of a front end load is the reduced amount flowing into the cash value at the start. Such front end loads can be based on actual amount of premium paid (most common), the face amount of coverage or a fixed one time fee (uncommon). **A back end load** has the disadvantage of assessing a charge which exceeds actual expenses. A back end load is deducted when a contract is terminated in the earlier policy years, usually the first through tenth and sometimes, fifteenth years. **A back end load is also referred to as a surrender charge**. Another common load procedure is to assess a **fixed percentage charge** (7.5% is currently used by many companies) against all new premium paid. Such loads are sometimes buried in mortality charges instead of being separately identified).

Any monthly administrative or ongoing charges are also deducted from cash values. Deductions for riders (if any) are added to the cost of premium before any interest earnings are credited. A state premium tax may by applied on premium deposited with an insurance company. The rate varies from state to state but is generally from two to four percent. Some states do not assess such a tax, but this is becoming rarer.

Interest Factors. The amount that survives deduction is placed in the policy account (cash value) and it is credited with an interest payment based on a specified rate of return. This **rate of return fluctuates according to market conditions** but is normally guaranteed for at least one quarter of a year (some companies fix the return for a full year). This is why Universal Life is classified as an interest sensitive insurance product. As general economic rates decline, an interest sensitive product can become less attractive to own than traditional whole life products because of the UL contract's potential for increased mortality cost. However, an interest sensitive product is an excellent hedge against increasing inflationary pressures since its yield may reflect the economic environment much more accurately than will the fixed internal rate of traditional whole life.

All expense and interest applications of Universal Life are summarized in the flow chart illustration below:

<u>PREMIUM NO.1 IS PAID</u>

SUBTRACT: Mortality Charges, Fees, Taxes, Other Expenses

ADD: Interest Paid

EQUAL: Cash Value at the end of
Premium No. 1

<u>PREMIUM NO.2 IS PAID</u>

NEW PREMIUM IS ADDED TO ANY CASH VALUE AND INTEREST DUE TO PREMIUM NO. 1 .

SUBTRACT: Mortality Charges, Fees, Taxes, Other Expenses

ADD: Interest Paid

EQUAL: Cash Value at the end of
Premium No. 1

ETC., FOR SUBSEQUENT YEARS 3, 4 , 5 ....

IRS Guidelines

Without going into great detail regarding tax treatment at this time, be aware that the interest payments credited to the cash value in a Universal Life policy are not immediately taxed. The interest credits accumulate with the cash values on a tax deferred basis. (This concept is discussed in greater detail in Part II "Federal Taxation Concepts). To prevent people from having too much of a good thing, the IRS placed certain restrictions, or “guidelines” as the government refers to them, on just how much premium can be placed in a Universal policy relative to the amount of life insurance in force.

The death benefit, expressed as a percentage of the policy account, must maintain a certain distance or **"corridor" (known as the IRS “risk corridor test")** of protection. A table of corridor percentages based on age is shown below. When the policy account reaches a certain percentage, the death benefit must be increased in a manner that provides the required amount at risk.

TABLE 3
IRS RISK CORRIDOR

Age of Insured	Required Ratio Of Insurance To Policy Account
40 and under	250%
45	215%
50	185%
55	150%
60	130%
65	120%
70	115%
75-90	105%
95*	**100%**

* Age 95 represents the endowment point of Universal Life, or the age at which cash value equals the death benefit. The death benefit is paid to the policyowner if the insured is still alive at age 95.

Another test is called the **"cash value accumulation test".** This means that the cash surrender value **can not exceed a required net single premium** for basically the same type of insurance being offered. The recent addition of the "modified endowment contract" (7-Pay Life test as discussed in Single Premium Whole Life) change in the tax law also applies. To be qualified as life insurance under the 1984 IRS code, the universal contract must meet either of the two tests described.

Without these IRS restrictions, consumers could purchase a policy that minimizes insurance protection while maximizing tax deferred cash value accumulation. This would lead to a situation tantamount to savings accounts with tax free accumulation periods. With the risk corridor, the IRS sets forth the minimum life insurance purchase required at specified ages for maximum cash deposit (premiums) amounts. Even with these restrictions, as we will see later, the opportunity for solid cash accumulation is very competitive compared to long term conservative investments that are not allowed tax deferred treatment.

Options A and B (Death Benefits)

Typically offered in the Universal contract, it is a choice of two patterns of death benefit. **Option A is a level death benefit while option B is a level net amount at risk.** Under option A, the risk corridor test is applied to make certain the cash value in the policy account is not exceeding the required ratio when applied against the level death benefit. Option A (or option 1 as it is called in some contracts, depending upon insurer) is similar to the manner in which a traditional whole life policy works. The death benefit stays the same as the cash value grows annually and eventually endows and the death benefit is paid. The net amount at risk to the insurer actually decreases each year as cash value amount increases.

Option B (or option 2, again depending upon the insurance company) provides a death benefit equal to the face amount purchased plus the value of the policy account. Option B is sometimes called, technically incorrectly, an increasing death benefit. However, since the original insurance amount purchased is paid PLUS the existing cash value, the amount at risk to the insurance company is LEVEL, not increasing.

OPTION A

DEATH BENEFIT (LEVEL)

$
/$ CASH VALUE
/$ INCREASES EACH
… **/$** YEAR AS PREMIUMS
……. **/$** ARE PAID.
TIME LINE> AGE OF INSURED INCREASES

OPTION B

/$
/$ CASH VALUE
/$ INCREASES AND
/$ IS PAID IN ADDITION TO
/$ THE DEATH BENEFIT PURCHASED

DEATH BENEFIT (LEVEL NET AMOUNT)

/$
/$ CASH VALUE
/ $ INCREASES EACH
/ $ YEAR AS PREMIUMS
/ $ ARE PAID.

TIME LINE> AGE OF INSURED INCREASES

The choice of death benefit option is the policyholder's. Keep in mind that under option B, the mortality charges are assessed to reflect the increases in cash value at all times, and therefore premium is higher for this option. The insured is always paying for the death benefit that is in effect at any given time.

<u>Special Features of Universal Life</u> Characteristics common to Universal Life are its flexible premium payment, a withdrawal feature and treatment of policy loans. Prior to the 1970's and a product called "Adjustable Life", all premiums were rigidly structured. The company told the insured the exact amount that had to be paid to keep the policy in force according to the contract. Universal Life is different. It allows the insured to decide both how much, and when, payment will be made. **This type of freedom is both a blessing and a curse.** If there is a major disadvantage to Universal Life it may well be caused by the ability to pay on this flexible premium basis.

Because of flexible payment, a major criticism of the UL contract is that it may be more prone to lapse than is the case with traditional whole life products because an insured does not have to make payments when they on a rigid schedule. In the early years of offering Universal Life contracts, insurance companies found a relatively high lapse ratio after the fourth and fifth years of policy ownership. To combat this problem of lapse, companies recommend a regular monthly payment be taken directly from the checking account of the insured (at the authorization of the insured, of course). Another technique to lower the lapse rate is to establish a planned or target premium. The policyowner sets the amount he or she wishes to pay and the company sends a bill as a regular reminder.

The **withdrawal feature of Universal Life is an interesting innovation.** It allows the policyholder easy, fast and convenient access to funds in the policy account for a small transaction fee. This is not considered a policy loan and therefore no interest charge is made against the amount withdrawn. The normal limitation on withdrawal: a policyholder should never withdraw an amount that exceeds the amount actually deposited (without considering any interest added to the total amount in the cash value). If a policyholder wishes to remove an amount greater than the total premiums actually deposited in the policy, a policy loan should be made. Otherwise income taxes are owed on any excess amount removed. **The FIFO,** or first in-first out, **accounting principal is applied by the IRS for removal of cash value from the policy account of Universal Life.**

<u>For Example:</u>

Assume Bob has paid $1,000 per year in his UL policy for ten years and his cash value now equals $15,000 (premiums paid MINUS mortality cost, fees and all other deductions PLUS interest earned).
Bob has paid in $10,000 and can withdraw up to this amount without any income taxation. However, if Bob wishes to retrieve more than $10,000 he will be taking interest which will be subject to income taxes, unless he elects to "borrow" the amount rather than "withdraw" it.

Even the policy loan provision of most Universal contracts is different than traditional policies. In the past, companies established a contractual rate of interest in the event the policyholder wished to borrow cash value from the policy. This changed in the early 1980's to a floating rate to reflect current market conditions, not to exceed some maximum percentage. Many companies offering a Universal Life contract set a fixed **policy loan rate** on borrowed amounts that **is**

offset, to a certain extent, **by a rate of interest that is credited to the money which has actually been removed.**

This **"ghost account",** as some have called it, **reduces the effective rate of interest owed on money borrowed.** This effective rate can range from 0% to 5%, but the norm is two or three percent. What is the reason for charging any interest at all? It enables the policyholder to utilize cash values in excess of the FIFO amount without being liable for income taxes. Which would you rather pay: two or three percent to an insurance company, or 15% through 38% to your Uncle Sam (plus more to your state government)? Since the UL contract owner is actually borrowing their own money, the requirement of a small loan interest rate avoids the imposition of income taxes when the cost base has been exceeded.

Typical Riders. Since Universal Life is a permanent plan of life insurance, the usual riders are normally available. Waiver of premium, term insurance on additional insured's and accidental death can be purchased for additional amounts. Of these riders, only **waiver of premium has a somewhat strange twist.** Since the cost of insurance in a universal product is based on current mortality charges and the premium is flexible, normal calculations of waiver of premium are not used. Waiver charges are normally assessed against actual cost of life insurance and not for larger amounts of planned or target premium. Waiver of premium for planned or target premiums may be available, but the cost assessed will reflect the higher amounts.

An **option to purchase additional insurance is generally available with Universal Life** in the same manner it is available with traditional insurance products. Due to its flexible and adjustable nature, Universal Life can adapt to fit the needs of the policyholder on almost a chameleon-like basis. However, **to increase the death benefit within the original policy, the insured is subject to meeting normal insurability requirements.**

VARIABLE LIFE

Variable Life, first introduced in the United states in 1976, is considered a permanent plan of life insurance and a **fixed premium is payable.** It is very different from traditional life insurance because it's product design is to base death benefits and/or cash values on a variable basis tied to a separate investment pool of assets. Since **Variable** Life's performance is associated with equity markets, it **is considered somewhat risky** and it can only be sold by agents registered with the National Association of Securities Dealers (NASD), SERIES 6 level, or higher. Financial planning experts agree in their caution to **purchase a variable life contract only in addition to meeting the normal death benefit need through other traditional sources of product (whole life, UL, term, etc.).**

Variable Life is approved in all states for sale, but it's **growth has been slow.** In the late 1980's it accounted for only about 3%-5% of market share, but market share has been slowly increased and it is expected to someday capture a major share. In general, **the product offers the potential to**

out-perform inflation in the long run because of its relationship to the stock market. Stocks have traditionally been a strong hedge against inflation, but short term fluctuations can be disruptive or upsetting to the unsophisticated investor.

To remove this short term susceptibility, variable products have expanded the number and types of accounts available for investment. In addition to stock accounts, and depending upon the product, the policyholder can direct funds into money markets, high growth stock funds, guaranteed accounts, global funds, balanced accounts and bond funds. Each Variable Life product **must supply a registered prospectus as an element of marketing,** in compliance with SEC (Securities and Exchange Commission) regulations.

A newer version of Variable Life called **Variable Universal Life combines some of the investment opportunities of Variable Life with the flexible premium payment aspects of Universal Life.** It also is an interest sensitive product and is the same as Variable Life except for this flexible ability to pay premiums. On the other hand, straight Variable Life requires a fixed premium be paid on a regular basis.

Current Mortality Charges.

As of January 1, 1989, insurance companies are required to use a 1980 CSO table for mortality on a national basis. The death benefit itself, under a typical variable contract, consists of two parts. There is a guaranteed death benefit which directly relates to the basic plan of life insurance stated in the contract. The second aspect of the death benefit is variable.

Payment of the fixed premium assures full payment of the face amount regardless of policy account performance. If the underlying investments in the policy account perform well, then an additional death benefit is added to the original face amount purchase. As once lofty returns diminish, so to will any extra death benefits. However, the minimum death benefit will not fall below the original face amount purchased.

Loading Factors.

Although transparent to some extent, cost is not as unbundled here as it is in a universal contract. In addition to mortality charges, there are deductions for state premium taxes, any riders selected and the usual administrative fees. One **cost unique to Variable Life is an asset management charge based on the securities portfolio.** Details of asset management charges are disclosed in the prospectus which must be provided to all prospects for Variable Life. The maximum sales load, with some exceptions, for Variable Life is 9% during the first 20 years of premium payment.

Interest Factors.

Unlike traditional life and universal products, there is **no cash value guarantee under a Variable Life contract.** The actual **cash value of variable policies will fluctuate daily,** based on the market performance of underlying securities. If the policy has a guaranteed conservative account available under the contract, the cash value or a specifically directed percentage may be guaranteed.

The overall return paid will be dependent upon cash amounts invested in various available accounts and the investment income they produce. Normally, companies allow a policyholder to switch cash amounts form one fund to another and a fee may be assessed.

If all the invested funds are in security type accounts, there is no guarantee of cash value. If more conservative accounts are chosen for placement of policy cash value, there will be little or no risk to capital. As discussed earlier, the concept of risk and return plays a key role in this contract. The placement of cash value into riskier accounts correspondingly increases the chance for gain or loss.

Possible Effect of Interest Factor on Premium Payment

Since a negative return could conceivably eliminate all accumulated cash values within a policy, **there are no cash value guarantees.** Investment **risk is placed solely upon the consumer in Variable contracts**. In the event all cash value is wiped out, the company would require the policyholder to pay additional premium to keep the policy in force beyond the original premium payment period. For this reason, a variable contract is not like any other insurance contract. All forms of traditional Whole Life insurance offer fixed and guaranteed premiums.

Typical Riders.

Riders available to the variable contract can include waiver of premium, term on additional insureds, accidental death and option to purchase additional insurance. Waiver of premium can protect the entire amount of the fixed premium payable under the variable contract or it may only pay the actual policy and insurance costs. A note concerning term on additional insureds: watch lapse due to cash value erosion very carefully. If the variable contract lapses, so do any coverages associated with it as riders. An option to purchase additional insurance, if it were available, would not be very attractive under a variable contract. Remember, the variable plan is supposed to be a hedge inflation because the underlying securities have historically out-paced inflation. The purchase of the Variable plan is supposed to be in addition to existing life coverage and is not meant to be just a substitute for it.

Interest Sensitive Whole Life

Premium Structure and Guaranteed cost.

Interest Sensitive Whole Life (ISWL) is designed to provide a **guaranteed and level** premium **cost** structure while also offering a **fluctuating rate of return** on guaranteed additions to accumulating cash values within the policy. **A fixed and guaranteed premium is required each and every year.** Like traditional whole life, ISWL has a cash value account which is owned by the insurance company until cash surrender, endowment or death. Therefore, any money removed through policy loans is assessed a rate of interest which matches current economic conditions.

The underlying premium cost is competitively based the current mortality charges assessed for permanent, or whole life, insurance contracts. This **cost is guaranteed once a contract is issued.** Policyholders may also benefit in the future if mortality rates continue to improve but such a condition is by no means a certainty.

<u>Cash Value Accumulation.</u>

Since **ISWL is a bundled product,** the consumer is unable to separate policy charges from returns. The ISWL contract adds a portion of regular periodic premium payments to guaranteed cash values. Although access to cash value is limited to policy loan procedures and interest charges, **liquidity is swift.**

The purchaser of an ISWL contract is looking for the certainty of **fixed mortality cost** and is willing to pay the required higher "up-front" charges. Since cost is fixed over the life of the contract, the policyholder is **paying more for death benefit in the early policy years** for the privilege of receiving a price break in old age (as the cash value nears the endowment point).

The surrender penalties are very steep in the early years of the contract because of the manner in which the expenses are incurred. Since commissions are relatively high in year one, no actual cash value is likely to exist. However, companies utilizing the back end load technique may pay interest on a fictional cash value fund. As long as the policyholder pays on time for the first 10 or 20 years, all surrender charges would vanish in the event surrender is requested.

Comparing and Contrasting Product

Universal Life vs. Interest Sensitive Whole Life

The main consideration in making the determination of whether to buy UL or ISWL hinges on **flexibility versus guarantees.** The freewheeling UL contract places considerable burden on the insurance agent to provide constant service while the policyowner must be more interactive in understanding the contract and its finer points. UL requires the owner to make many different policy ownership decisions.

Since the underlying **mortality charge in** the **UL** contract **is** one of **"current cost term",** the death benefit cost will likely increase each year with age. The contract will indicate the highest possible charge for mortality (in the table of guaranteed cost), a price generally double or triple "current" cost. If the policyowner grows older and careless when it comes to increasing premium payment amounts, he can be in for an unpleasant surprise and have no coverage.

Perhaps no decision is as complex as the one to decide the initial and subsequent premium payment amounts. **On the low end, the owner is required to pay only the current cost** for mortality on a yearly term basis plus any other policy expenses. Under this scenario there will be little or no cash value accumulation.

The **other extreme would be to pay a single premium** such that the entire contract was fully paid. This possibility allows for an initial maximum cash value which in turns earns a competitive rate of return.

he earned interest would be ample to pay all present and future policy and insurance costs while allowing continued policy account growth. Between these two options, any amount is fair game and within the definition of insurance as determined by the Internal Revenue Service .

Beyond the decision of establishing premium is the further option of skipping and/or altering subsequent premium payment amounts. The insurance company strives to solve this dilemma by suggesting **the target premium.** This target sees to it that all costs are paid while cash values accumulate on a schedule assuring endowment by age 95.

On the other hand, an ISWL purchase carries with it a required and fixed annual premium payment, thus relieving the consumer of the obligation to decide. If you do not pay exactly what is owed within the grace period, your policy will lapse and fundamental contractual rights may be forever lost. Premium payments under the ISWL contract are comparable to traditional whole life in this regard of fixing and guaranteeing premium.

When it comes to **retrieving cash values, UL and ISWL are fundamental opposites.** The UL policyowner pays for all policy costs as they actually become due, therefore all money in the policy account is over and above policy cost. This means **the policyowner owns the cash value in the UL contract**.

Under an ISWL contract, the insurance company owns all cash values. If the policyowner wishes to use the funds, he must borrow at competitive rates of interest. At death, endowment or cash surrender, the contract concludes and the policyowner then takes possession of all existing cash value (or face amount).

In answering the fundamental question of **which plan should an individual choose,** it must first be decided **which aspects are more appealing to the particular consumer involved: flexibility of premium payment and easy access to cash value or fixed guaranteed price?** UL will be more popular for people craving flexibility while ISWL is the more comfortable choice for individuals who like to know that price always stays the same.

Universal Life vs. Variable Life

The most obvious difference between these two contracts is that **UL** policy accounts earn a **rate of return** carrying some minimum **guaranteed** amount (commonly 4.5 to 5.5%), while **Variable** contracts place **all investment risk on the policyowner.** Variable contracts normally offer investment refuge within a guaranteed account for the timid, but the returns are the same as they would be in a UL product. Anything invested outside of this guaranteed account is placed in a **"separate account"** where anything can happen and all money could be forever lost.

Since the long term UL policy account is intended to accumulate safely and somewhat predictably, opportunities for exciting profitability are unavailable. The main concern of UL is to provide a death benefit as expected, when it is needed. The Variable contract owner is more interested in investment returns on cash values which will (hopefully) far exceed the rate of inflation. Death benefit, although a consideration, takes a backseat to long term profitability. Variable life owners are supposed to understand the nature of the risk involved.

The other central distinction is, of course, focused on premium payment schedules. **UL allows enormous flexibility** while **Variable Life requires annual and fixed payments.** In UL, both the amount and frequency of premiums can be altered based on individual preference. Variable contracts can lapse without the timely payment of premiums.

Variable Life vs. Interest Sensitive Whole Life

Both Variable and ISWL require a fixed and level premium payment each year. Other than this similarity the other comparisons are sharply different. ISWL offers guaranteed premium throughout the length of the contract while Variable contracts usually charge for mortality on a "current term" basis in which mortality cost increases every year.

ISWL provides a basic guaranteed interest payment on cash value (usually around 5%) but (higher) current returns are paid based on medium (3-5 year) bond yields. The variable contract rate of return can range from exceptional to dismal depending upon a myriad of investment variables.

Again, the ISWL purchaser should mainly be concerned with the death benefit purchase while the Variable owner places priority on cash value and rates of return even though risk to principal is present.

What is the Best Choice?

All these alternatives bear strengths and weaknesses relative to individual preferences. If you know your main weakness is disciplined saving, then selecting a program with flexible premium may not be the best decision. On the other hand, if a consumer is willing to risk losing principal in exchange for an exciting return, then a Variable contract could be the answer.

The consumer's best chance for proper selection is based on knowing his or her own investment preferences and tolerance levels for risk versus return. Another factor is the financial advisor the consumer has elected to retain. Obviously, the insurance agent licensed to sell securities products is in a much better position to serve the insurance and investment needs of a much broader range of clientele.

The table below summarizes various contract comparisons which have been made in the preceding text.

TABLE 4
Interest Sensitive Product Comparisons

UL= Universal Life; VL= Variable Life
ISWL = Interest Sensitive Whole Life

	UL	**VL**	**ISWL**
Annual Premium Requirement	FL	FX	FX
Rate of Return	G	Not G	G
Mortality Cost	Current Term	Current Term	LV&G
Cash Value Access	W or L	W or L	L only
Death Benefit Option?	OP A or B	OP A or B	LV&G
Is Coverage Suitable as Basic Death Benefit?	YES	NO	YES

KEY: **FL**=flexible; **FX**=fixed; **G**= guaranteed
W= withdrawal; **L**=loan; **OP**=option **LV**=level

Single Premium Whole Life

NOTE: Tax law regarding Single Premium Whole Life (SPWL) was changed, effective June 21, 1988. In order to provide you with a better understanding of what changes have occurred, as well as the reasoning behind the changes, a discussion of tax treatment from 1984 until June 20, 1988 is also included. It is important to understand history as a link to the present.

For purposes of the included open book examination, you will be tested only on current taxation issues (June 21, 1988 and after) which follow.

Single Premium Whole Life, or SPWL for short, has been offered for many decades. It was never a very popular policy in terms of number of policyholders because of the high, one time payment that must be made. SPWL is the extreme form of limited pay whole life plans. The insurance death benefit purchased is completely paid at the inception of the policy. Therefore, cash and loan values are substantial immediately.

Tax Treatment 1984 to June 20, 1988

SPWL became very popular due to the favorable tax treatment given to insurance policy cash values after the 1984 tax law was implemented. A purchaser of SPWL enjoyed interest accumulation upon his entire premium at competitive, current rates of return. At the end of a year, the policyowner could remove all the interest generated from the cash value with a "wash loan". The wash loan meant that the policyowner could "borrow" his entire income earned for the year at a rate of interest that was simultaneously credited by the insurance company with the same exact amount. This amounted to an interest-free loan. Combine this with the fact that any money removed in an insurance policy through a loan is not income taxable, even if income is being borrowed, and the reason for the popularity of this product becomes quite clear. Many millions of dollars began to make their way from taxable Certificate of Deposits at banks and savings and loans to the tax free SPWL policy.

Congress became sensitive to what it considered an abuse of the original intent of insurance taxation with respect to policy loans and the tax law was amended. Most of the initial attention of this flow of funds from banks to insurance companies was brought about by the banking industry because they viewed this brand of disintermediation as a threat to their customer base.

Current Taxation (June 21, 1988 to present)

Whether or not a current contract is considered "life insurance" or a possibly a taxable investment depends upon a **7-pay net premium test.** Cumulative premiums paid on a life contract may not exceed the cumulative payments under a 7-pay net premium basis. If premium payments exceed this 7-pay test (i.e. 6-pay life, 5-pay.... single premium) the contract no longer qualifies as life insurance. Instead, the contract becomes a **"modified endowment contract (MEC)."**

A modified endowment will still treat accumulating cash values like it is a life insurance contract, but any money received as dividends, withdrawals or surrenders are treated like amounts received under annuity contracts: **last in-first out (LIFO).** First-out money is considered income and is therefore taxable.

In other words, a SPWL is still life insurance with respect to tax deferred accumulation for cash values. However, any attempt to withdraw money creates a taxable event if the money taken is in excess of premiums paid. Leave the cash alone and it is life insurance, take money out and it is a modified endowment and treated like an annuity.

Historically, this new treatment stems from the 1984 tax reform which defined Universal Life as a life insurance contract but knocked endowment insurance out of existence by treating it like an investment. Therefore, this new rule looks at SPWL (or anything less than 7-pay life) as both a life insurance policy and an investment, depending on what action is taken by the consumer.

If the consumer treats the SPWL like life insurance (long term, and does not touch the cash value) the tax law goes along and allows tax-deferred cash accumulation. However, if the consumer wants to remove cash, any amounts above his cost base are treated like investments: as taxable income. Therefore the consumer now can have his cake, but he can't eat it without paying the price of income taxes.

Basis of Premium Charge.

Attained age is used to determine the percentage of death benefit that is necessary as the one time premium charge. The 1980 CSO table of mortality has made the rates much more attractive than they were previously.

However, they are still beyond the means of most people for any significant level of protection.

The minimum premium usually starts at $5,000 for minor children and $10,000 for adults. The older a person is, the less death benefit he or she can purchase with a fixed amount of premium.

Loading Factors.

In addition to favorable tax treatment, the manner in which SPWL has been loaded since 1984 is also a reason for more enthusiastic reception. A back-end surrender charge is typically used. This enables the entire amount of premium deposited to be credited with a current interest rate factor even though 10%-18%, depending upon the company, is put toward expenses and required reserves.

Bailout provisions are offered by some companies as an added protection for consumers. Under a bailout, if credited interest rates fall below a level guaranteed in the contract, the policyowner is allowed to surrender the contract without paying a surrender charge. Most bailout would fall within the four to six percent range.

Interest Factors.

Generally, SPWL provides both a current rate of interest credited to premium deposited and a guaranteed minimum rate. Typically, a company will guarantee a current rate for 1, 2 or 3 years and establish the guaranteed minimum. Through the mid to late 1980's rates have declined to match both inflation and more conservative rates of return. Initial rates that began at 10%-11% fell to 7%-9%. By the mid-1990'5 they were at or near the minimum (bailout) amounts. The main group of consumers currently attracted to the plan would include older more prosperous individuals looking for safe returns and greater life insurance coverage. Obviously if interests rates, fueled by inflationary pressures, increase, the interest paid on SPWL will rise as well.

Annuity

An annuity is a series of payments made for a specified period of time. It is a “life” insurance contract, but any similarity between an annuity and death benefit life insurance is purely coincidental. Annuity has sometimes been called reverse life insurance because payment generally ceases upon the death of the policyowner(s) as opposed to beginning upon the death of an insured. Payments made to annuitants are based on actuarial tables of life expectancy. Theoretically, if everyone lived to anticipated maximum age limits, it would mean annuity providers (insurance companies) would not suffer a loss or make a profit. In this manner, people who die prematurely enable those who live unexpectedly long lives to continue receiving benefits.

The role of an annuity is to liquidate an accumulated fund over a prescribed period of time. Earlier mention was made of the use of an annuity to payoff an Illinois Lotto lottery winner. Annuity can be classified in many ways including: number of lives covered, premium payment method, commencement of payment, fixed or variable units of accumulation and method of proceed distribution. Annuities are also quite often used in structured settlement situations. Structured settlements occur as the result of lawsuit agreements as an option for long term payouts to successful plaintiffs. Annuity will be discussed both in general as well as with specificity where interest sensitivity is concerned.

Annuity has become increasingly popular, especially in the area of retirement planning. Various tax advantages have made annuity the preferred method of accumulation compared with life insurance with some consumers. A solid understanding of annuity is essential in today's marketplace.

General Discussion of Annuity

Immediate & Deferred Annuity.

Income benefit payments can begin immediately or at a specified point of time in the future (this is referred to as a deferred annuity). Intervals between which payments can be received are normally monthly, but any mutually agreed upon (and financially sound) frequency is generally acceptable. An immediate annuity is made with a single premium payment. Payments begin at the next frequency interval. Deferred annuities can be purchased as the result of making a single payment or through a fixed or flexible periodic premium payment plan. IRA's (Individual Retirement Accounts) funded via an annuity are of a deferred nature with an annual or regular monthly premium payment that is fixed or flexible.

Payment Modes.

Annuity has **two general payment classes: pure and refund**. The **pure, or straight life, annuity** provides income at regular intervals contingent upon the life of the annuitant. Under a pure annuity, payment stops at the death of the annuitant. In other words, if the annuitant purchased a single payment immediate annuity last month and died this month, only one payment would be made and the insurance company retains the balance. Conversely, a **refund annuity** pays benefits for as long as the annuitant lives and provides a refund to a beneficiary if the annuitant dies prior to receiving a benefit amount that equals the premium paid. Period certain annuities are a form of refund annuity.

In a **period certain annuity** contract, a guaranteed payment is made for life or for a specified period of time (usually 10 or 20 years), whichever is longer. The annuitant would receive payments for as long as he or she may live or for the period certain if death occurs prior to the completion of the period certain. Any remaining, yet unpaid, benefits are sent to either a named beneficiary or to the estate of the annuitant, if no beneficiary was named.

Payments under a pure annuity are higher than those under a refund or period certain contract. The longer the guaranteed period certain, the smaller the benefit payment. A refund or period certain annuity differs from a pure annuity because not all of the purchase price is used to provide the annuitant with income payments.

Payments can also be tied to more than one life. **Joint and last-survivor annuity** provides for payment to continue for as long as either of two or more lives still live. Since income will theoretically be paid for a longer period of time than just one life, the periodic benefit paid will be a lower amount. Many companies pay one-half or two-thirds of the original amount to the survivor.

The annuity products offered by insurance companies that provide guaranteed amounts of fixed income are backed by assets invested in the insurer's **general account.** These annuities are marketable because they pay a return equal or superior to the returns available through other sources. Return is usually greater than through other income methods because return (liquidation) of principal is paid in addition to interest earnings. Since annuities are guaranteed for life, the annuitant cannot outlive the income. Favorable tax treatment is also an excellent reason to purchase an annuity. One drawback to this type of fixed annuity is the possibility that future inflation will significantly diminish the purchasing power of the fixed benefit payment. **The Variable Annuity was designed to overcome the inflationary effects of time.**

The Variable Annuity Contract

The assets that back the Variable Annuity contract are maintained in a **separate account** (as is the case with Variable Life insurance) and investment results directly affect the value of the individual annuity owned. The key concept at work is, that over the long term, returns on common stock and other investments will better keep pace with inflation compared to the return on a fixed income investment vehicle. Historically this has been the case, but there are no future guarantees that such a scenario will continue, as the obligatory warning placed prominently upon the required prospectus will attest. This warning illustrates the basic concept of risk and return: because the potential for gain is greater under a Variable Annuity contract, so too is the possibility for loss.

Under a non-variable or fixed annuity, the insurance company guarantees a minimum rate of return while the fund is accumulating and also guarantees a fixed payment amount in the future. The variable contract offers no such guarantees and therefore the risk of investment is squarely upon the shoulders of the annuitant.

Annuity is used in both tax qualified and nonqualified markets. They can be used to fund pension and profit sharing plans that are qualified under the IRC code. The tax-deferred annuity (TDA) or tax-sheltered annuity (TSA) have been popular for years and is available to the employees of public educational institutions and specified tax-exempt organizations.

STUDY GUIDE – SECTION I

SECTION I - PRODUCT REVIEW (COMPLETING THIS SECTION IS ENTIRELY OPTIONAL.)

The following short answer essay Questions are designed to help you:

1) Learn the preceding material more thoroughly and

2) enable you to more easily take and complete the assigned 50 question multiple choice exam.

All essay questions follow the written text in the exact order in which it is presented. Answer in the space provided or on separate sheets of paper.

COMPLETING THIS SECTION IS ENTIRELY OPTIONAL.

QUESTIONS 1-4 PERTAIN TO
"HISTORICAL PERSPECTIVE AND ECONOMIC DISCUSSION"

1) What is the function and goal of a financial intermediary?

2) In the 1950's what were three advantages to purchasing an endowment life insurance contract as opposed to saving money in a bank or savings and loan passbook account?

3) What is the main purpose for purchasing life insurance?

4) List life insurance product evolution in terms of greatest popularity from the 1950's to the early 1980's, as follows:

a) 1950's ______________________________

b) 1960's - 1975 ______________________________

c) 1976 - 1983 ______________________________

QUESTIONS 5 & 6 REFER TO
"VARIABLE VS. FIXED RATES"

5) List and explain the general investment rule (the relationship of risk to return).

6) What type of return do you favor: fixed or Variable? Why?

QUESTIONS 7 & 8 PERTAIN TO *"FUTURE AND PRESENT VALUE CONCEPTS"*

7) Why are present and future value of money considerations important in setting and working toward financial goals?

8) How could the 1967 Consumer Price Index be used as an effective tool in an insurance sales presentation?

QUESTIONS 9 - 16 REFER TO
"UNIVERSAL LIFE"

9) List three main differences between UL and traditional whole life products as indicated below:

a) Premium Payments:

b) Mortality Pricing:

c) Cash Value Ownership:

10) Briefly explain each of the following load variable concepts.

a) Front end load:

b) Back end load:

c) Fixed percentage charge:

11) Describe the process by which part of the premium paid for UL contracts is credited with interest.

12) Explain, in general terms, minimum and maximum premium payments allowed for a UL contract according to current tax law.

13) How do Option A and Option B benefits differ from each other?

14) Why are flexible premium payments both a "blessing" and a "curse" to the UL contract owner?

15) What is the purpose of a "ghost account"?

16) How can the purchase of Waiver of Premium in a UL contract differ from the same purchase in a traditional whole life policy?

QUESTIONS 17 - 20 PERTAIN TO *"VARIABLE LIFE"*

17) What can be considered unusual about the crediting of interest payments to cash values owned within a variable life contract?

18) On what basis is mortality charged in variable life?

19) Give two expense loading concepts found in variable which are not found in non-variable policies.

20) What are a few of the investment account choices facing the VL policyowner?

QUESTIONS 21 & 22
REFER TO "INTEREST SENSITIVE WHOLE LIFE"

21) Describe the basic product design of ISWL.

22) Under what conditions can the ISWL policyowner gain access to cash values without effecting a total surrender?

QUESTIONS 23 - 25 REFER TO *"COMPARING AND CONTRASTING PRODUCT"*

Briefly list main differences and similarities between:

23) UL and ISWL:

24) UL and VL:

25) VL and ISWL:

QUESTIONS 26 & 27 PERTAIN TO
"SINGLE PREMIUM WHOLE LIFE"

26) Describe a Modified Endowment Contract.

27) In your opinion, what is the profile (age, financial status) of the more typical purchaser of SPWL?

QUESTIONS 28 - 30
REFER TO ANNUITY

28) Simply define "annuity".

29) List and briefly describe four basic annuity benefit types.

30) Explain the difference between a "general" and "separate" account.

PART II: FEDERAL TAXATION AND ADVANTAGES

Volumes could be written to describe all the uses of insurance products in both the individual and group marketplace and their relationships to taxation concepts. This analysis shall be restricted to some fundamental tax concepts while paying particular attention to the five interest sensitive insurance products already discussed.

The analysis start with the IRA, both under the TRA of 1986 and changes which occur with the passage of the Taxpayer Relief Act signed into law August of 1997.

IRA Under The Tax Reform Act of 1986

1) DEADLINE TO ESTABLISH AN IRA - An IRA can be established and funded at any time between January 1 of the current year and the due date the individual income tax return; i.e., April 15th of the following year. **Extensions for filing the tax return do not extend this period.**

2) CAN THE DEDUCTION BE TAKEN PRIOR TO THE INVESTMENT OF THE FUNDS? - Yes. This, in effect, permits an individual to file his return early in the year; e.g., January, and use his or her tax refund to make the actual contribution prior to April 15th. Revenue Ruling 84-18, 1984-1 CB 88.

3) TWO TYPES OF IRA ARRANGEMENTS PERMITTED

a) INDIVIDUAL RETIREMENT ACCOUNTS
--a trust with a corporate trustee

b) INDIVIDUAL RETIREMENT ANNUITIES
-- a special qualified annuity issued by an insurance company

4) EFFECTS OF OTHER RETIREMENT PLANS

Taxpayers (or their spouses)can make fully deductible IRA contributions up to the greater of their combined or $2,000 each, if their Adjusted Gross Income is below $40,000 if married filing jointly; $25,000 if a single taxpayer; and zero if married filing separately. If Adjusted Gross Income exceeds these amounts, the $2,000 limit is reduced by a formula which eventually permits no deduction, i.e., no IRA contribution is deductible for married couples (filing jointly) with Adjusted Gross Income over $50,000; single persons over $35,000; and married filing separately over $10,000. Employer Plans include regular qualified plans, Keogh plans, Section 403(b) tax-sheltered annuity plans, SEP (simplified employee pension) plans, and state, federal, and local government plans (not Sec. 457 non qualified deferred compensation plans.) Individuals with income in excess of the above limits may still make IRA contributions on a non deductible basis, so as to benefit from the tax deferred growth.

5) TYPICAL PAYOUT PLANS - SINGLE SUM DISTRIBUTION - becomes part of Taxable income for that year. LIFETIME OF THE PARTICIPANT (and his or her spouse, if desired). To avoid penalties, minimum distributions must be made each year; however, life expectancy can be recalculated each year to Minimize actual distributions. A FIXED PERIOD OF YEARS - The period cannot exceed the participant's life expectancy (or joint life expectancies of the participant and spouse).

6) DISTRIBUTION PERIOD **-** Distributions generally cannot begin without a penalty until age 59 ½ or if the individual is disabled or dies. Distributions must begin by April 1 of the year following the calendar year in which the participant attains 70 ½ or actual retires, if later.

7) PREMATURE DISTRIBUTIONS **-** Withdrawals or distributions prior to age 59 ½ (other than for disability, death, Medical expenses in excess of 7.5 percent of AGI, and amounts allowed for health insurance payments during periods of unemployment) are normally subject to a 10 percent penalty and are subjected to current income taxation of the distribution, unless such distributions are made over the life expectancy of the IRA owner or joint life expectancy of the owner and a designated beneficiary. The distribution schedule cannot be modified for at least 5 years or attainment of age 59 ½, if later.

8) TAXATION **-** During Lifetime: Distributions are taxable as ordinary income. At Death: At the participant's demise, the distributions received by a beneficiary are taxed as ordinary income. Distributions must be paid out over a 5-year period or less (or over the life expectancy of a beneficiary, if such a schedule is elected Within one year of the participant's death), unless they are paid to the surviving spouse; in which case they can be paid over the life expectancy of the spouse and begin when deceased participant would have attained age 70 ½. For Federal Estate Tax purposes, the death benefit is included in the gross taxable estate of the participant and may incur a 15% "excess accumulation" tax.

9) IRA INVESTMENT ALTERNATIVES - Generally, the best type of an investment for an IRA is one with a high cash flow since it is not currently taxable in the IRA account. High growth assets are usually better investments for the taxpayer's non-IRA dollars.

A. BANK AND SAVINGS AND LOANS: Certificates of Deposit are protected by FDIC and FSLIC. Fixed and Variable rates. There may be stiff penalties for early withdrawal.

B. ANNUITIES: Individual Retirement Annuities issued by insurance companies. May include a disability waiver of premium provision.

C. MONEY MARKET: Yield fluctuates with the economy. Can't lock in the higher interest rates. Easy to switch to other investments.

D. MUTUAL FUNDS: Trades are permitted within a family of funds without a penalty. Capital gains are taxed as ordinary income at withdrawal.

E. ZERO COUPON: Bonds bought at a deep discount originally. No interest payments to worry about reinvesting.

F. STOCKS: Wide variety of investments. High returns are possible. Capital gains are taxed as ordinary income at withdrawal. Losses are not deductible.

G. LIMITED PARTNERSHIPS: Some Limited Partnerships are especially designed for Qualified Plans; specifically in the areas of energy, real estate, and mortgage pools.

10)PROHIBITED INVESTMENTS OR TRANSACTIONS FOR IRA'S -

A. LIFE INSURANCE - **IRA accounts cannot include life insurance contracts.**

B. LOANS TO IRA TAXPAYER - Self borrowing triggers constructive distribution of the entire amount in an IRA. It becomes currently taxable plus a 10 percent penalty, if less than 59 ½. IC Sec. 408(e)(2)

C. COLLECTIBLES -Purchases of art works, antiques, metals, gems, Stamps, etc., will be treated as a taxable distribution. (Coins issued under state law and U.S. gold and silver coins are exceptions.)

D. DEBT FINANCED - **Any borrowing to invest; e.g., buying stock on Margin**.

Planner’s Note; for IRA investments consider the following 1) For money market IRA accounts are the interest rates offered fixed or variable? If interest rates drop, a fixed rate is better, especially if you can make future contributions at the same fixed rate. If interest rates go up, you may be able to roll the account over to another IRA. 2) How is yield calculated? More frequent compounding will produce a higher return. 3) How often can you change investments, and What is the charge?

11. IRA ROLLOVER AS A QUALIFIED PLAN CONDUIT -When an employee terminates employment or a qualified plan is terminated a special IRA arrangement can be used to hold a qualified plan distribution until it is transferred into a NEW qualified retirement plan. Tax-sheltered Annuity distributions may also be rolled to an IRA rollover account. This will defer current income taxation of the qualified plan distribution, as long as they are left in the IRA rollover account or moved under one of two options.1)another IRA, or 2)another Qualified Plan (if it permits). This will requalify the funds for special 10-year averaging. To avoid the harshness and back-up withholding of this 60-day rule, whenever funds are transferred from plan to plan, direct transfer arrangements should be established.

12) OTHER IRA TAX CONSIDERATIONS

A. A "Qualified Lump Sum Distribution" must include everything standing to the account of the participant and must be completely distributed within one calendar year. The participant must be at least **59 ½ or disabled** or there must be a separation from employment or a plan termination. Partial rollovers are permitted as long as more than 50% of the distribution is rolled over. The balance would be taxed as ordinary income.

B. Nondeductible employee contributions cannot be rolled over to the IRA. Noncash assets which are distributed can be sold and the cash proceeds transferred to the IRA rollover without realizing a current tax on any gain.

TABLE 5

DOES IT MATTER WHEN YOU CONTRIBUTE TO AN IRA?

When contributions to an IRA are consistently made at the beginning of the year rather than at the end, the funds have an extra 12 months in which to grow. Over a period of years there is a substantial difference in the amount accumulated.

$2,000 PER YEAR ACCUMULATED AT 7% AND 10% RATE OF RETURN

Number of	**7 % RETURN**		
Years From Beginning of First Year	Contrib. Made Jan. 1	Contrib. Made Dec. 31	Increase in Amount Accumulated
5	$12,306	$ 11,501	805
10	29,567	27,633	1,934
15	53,776	50,258	3,518
20	87,730	81,991	5,739
25	135,353	126,498	8,854
30	202,146	188,921	13,225
35	295,825	276,474	19,351
40	427,260	399,270	27,990

TABLE 5 (CONTINUED)

Number of ears from the beginning of the first year	10% RETURN Contrib. Made Jan. 1	Contrib. Made Dec. 31	Increase in Amount Accumulated
5	$13,431	$ 12,210	1,221
10	36,062	31,874	3,188
15	69,899	63,544	6,355
20	126,004	114,549	11,455
25	216,363	196,694	19,669
30	361,886	328,988	32,898
35	596,253	542,048	54,205
40	923,702	885,186	88,516

IRA Under The Taxpayer Relief Act

Effective in 1998 and beyond, the Taxpayer Relief Act signed into law in August of 1997 was intended broaden existing tax benefits of IRA's as well as to create new forms of the IRA. One of the main effects of the new act is two remove the barrier on couples when one spouse is covered in a qualified p lan through work and the other is not. Beginning in 1998, a spouse without a qualified plan at work can make a deductible contribution if the joint income of the couple does not equal or exceed $150,000, even if the other spouse is in a qualified plan.

Although Adjusted Gross Income will still be the guidepost for contribution deductibility when a taxpayer is already in a qualified plan, the limits will be raised to the following levels by the year indicated:

SINGLE
TAXPAYER: $50,000 -$60,000 by the year 2005

MARRIED
FILING
JOINTLY: $80,000-$100,00 by the year 2007

Under the new ruling, accessing IRA funds without an early withdrawal penalty has been extended to the following uses:

HIGHER EDUCATION COSTS (includes books, fees supplies in addition to tuition).

FIRST TIME HOME BUYING

Although the above broadening has been in effect for years for employer sponsored qualified plans, this is new territory for the individual retirement investor.

The "Roth" IRA

The Taxpayer Relief Act of 1997 also creates new forms of IRA, most notably the "Roth" version so-named for its Senate sponsor. The Roth IRA **allows contributions of after tax dollars which can be later removed at retirement *income tax free* along with any accumulated income**. The ability to fund the Roth IRA is also limited to maximum of $2,000 ($4,000 for a married couple) and contingent upon the following AGI limitations

SINGLE
TAXPAYER: $95,000 -$60,000 after 1997

MARRIED
FILING
JOINTLY: $150,000-$160,00 After 1997

The Roth IRA is further limits contributions by taking into account any contributions to all other IRAs an individual may own. In order to qualify to remove money tax free from a Roth IRA, the owner must satisfy a five year holding requirement (it begins at the point as which the Roth IRA receives either an initial deposit or rollover) and is age 59-1/2 or becomes disabled or dies. Also, amounts may be used for first time home purchasers.

The Roth IRA is considered to be a very complex and this discussion has only been meant to highlight a few main points. For more details on how these rules affect any individual it is highly recommended that a tax professional be consulted.

Some argue that the Taxpayer Relief Act, because of its complexity may hinder, rather than help, motivate Americans to save more money for retirement. Only time can reveal the actual impact of broader and new versions of the IRA.

Non-qualified Markets

If an individual wants to establish an accumulation fund outside of pension, profit sharing or individual retirement accounts (qualified programs), the use of nonqualified plans are available. Non-qualified means the money used for funding is an after tax contribution (However, this discussion does not pertain to the Roth IRA which is a qualified plan). Income taxes have already been paid on the cash which is then placed into a financial instrument offering tax deferred accumulation.

Two prime examples of the use of products for a non-qualified use would be life insurance and annuity investment. An individual who purchases a life insurance contract must use after-tax earnings for the purchase, except when purchased as a part of some qualified pension programs. The same is true of annuity purchases meant to augment retirement planning.

What is a main reason an individual would purchase life insurance or annuities with after-tax dollars? Earnings can accumulate at current interest rates with no income taxes due until some form of withdrawal begins. The advantages of a fund allowed to accumulate without yearly taxation is enormous when compared with an account which is taxable. Insurance products have long offered safe, secure and predictable rates of return without current income taxation.

Proceeds of Life Insurance.

The taxation of life insurance proceeds must be viewed from two points of taxation: income and estate. Generally, the proceeds paid under a life insurance contract are income tax free. This is true whether they are payable to the estate or to a named beneficiary. Furthermore, in the case where a beneficiary is named, the proceeds are payable outside of the probate process. Basic exceptions to this rule are the transfer for value rule and failure of the product to meet the Internal Revenue Code's definition of life insurance. However, both of these concepts are far too complex to be dealt with for purposes of this course.

Death benefit life insurance proceeds are generally includable for federal estate taxation purposes into a decedent/insured's gross estate. This is important knowledge because large policy amounts can substantially add to the value of an estate and, therefore, the estate's taxation. The general rule of estate taxation, regarding individuals who die in 1987 and later years, requires those leaving an estate valued greater than $600,000 (up through the end of 1997 with incremental increases thereafter) to file a federal estate tax form.

Interest Sensitive Insurance: The Policy Account

There is wide difference between the manner in which Universal Life, Variable Life and SPWL are marketed with respect to their policy accounts. No matter which marketing techniques are used, all companies must make certain their product always meets the required definition for life insurance. Additionally, great concern must be shown when marketing to avoid making any claims or statements which may be considered deceptive.

UNIVERSAL LIFE

A basic review of the policy account of Universal Life reminds us of the unique stature of this product in the marketplace. The basic philosophy of Universal Life is to demonstrate that it is possible to "buy term and invest the difference" and still have a permanent life insurance plan. The premium remaining after mortality charges, premium taxes and other expenses lands in the policy account and is regularly credited with interest at current rates (refer the comprehensive discussion of Universal Life in Section I for a review). During accumulation, no income taxes are charged.

The policyowner has access to the money in the policy account at all times. No income taxes will be incurred if the policyowner does not withdraw more cash than has been deposited as cumulative premium. If the policyholder wishes to withdraw (not borrow) in excess of cumulative premium deposits made, then any excess amount withdrawn is considered taxable income. The reason for the taxation of this excess: it is interest income.

However, if the policyowner wishes to tap into his interest income without causing a taxable event, he must make a policy loan. In taking a loan, most companies assess an interest charge that is to some extent offset by an interest credit on the borrowed funds. Technically it is the option of the policyowner as to whether or not loan repayment will be made. To put all this into perspective, consider the following example:

Mr. Smith owns a $100,000 Universal Life plan in which he has deposited $10,000 in premium. His policy account stands at $15,000. Mr. Smith can withdraw up to $10,000 without causing a taxable event. Furthermore, he can have access to most of the remaining $5,000 in his account in one of two ways:

(1) he can withdraw it and pay income taxes or
(2) he can borrow it at 8% while receiving an interest credit of 6%, thus incurring a 2% actual interest charge.

If the policyowner elects to the replace some or all monies withdrawn or borrowed, he may do so at any time. Normally, the policyowner must specifically state that a payment is a regular premium payment, a replacement of withdrawn funds or a loan repayment. Otherwise the payment will be credited in a manner specified in the contract. It is wise to replace withdrawn and borrowed funds before paying new premiums because no state premium taxes will be charged on replaced funds since, technically, these taxes have already been paid.

One further consideration to the dilemma of borrowing versus withdrawal is **IRC section 7702** which makes it clear that, in the first 15 policy years of Universal Life, the safest course of action is to borrow. Until the 16th policy year, a "partial squeeze out" may create an income tax liability on some withdrawals. This is a very complex issue and it requires far more analysis than it is worth for this course. Suffice it to say that a policy loan is the simplest alternative when in doubt.

A final **loophole** which can be of great benefit to wealthier clients when doing comprehensive estate planning is to **buy a substantial UL contract with an Option 2 death benefit funded with a single premium payment.** This creates a modified endowment contract but, **since the death benefit is "level net", the tax deferred cash accumulation of <u>the policy account is paid upon death as part of the income tax free death benefit</u>**. This is a tremendous planning advantage to individuals with large net worth who are seeking to pass substantial amount of money to heirs at death while minimizing taxation.

<u>VARIABLE LIFE</u>

The policy account in Variable Life (VL) has some different rules differently than Universal Life (UL). UL establishes a policy account that is conservative in nature and has guaranteed values. VL establishes a policy account tied to the performance of equity and security markets and cash value is not guaranteed unless some or all of the policy account is placed in a guaranteed account within the VL contract.

A policy loan under a VL contract has some interesting and unique aspects. A maximum cash loan is usually restricted to 50%- 75% of the cash value, using the policy for security. Why is a maximum cash loan restricted to only three quarters or less of the actual amount? Because, as you may recall from earlier discussion, the underlying policy account is not guaranteed. A customary fixed and moderate rate of interest is sometimes assessed to the loaned amount while other contracts use the "partial wash" concept.

If the security account in which the policy value is placed suffers losses great enough to vanish remaining cash values, the policyowner will have to make an additional premium payment to avoid policy lapse.

Also consider the permanent effect a policy loan will have on the cash value. Less principal results in less earned interest. Additionally, there can also be permanent impact upon the death benefit amount. The ability of the death benefit to rise above guaranteed levels would be adversely affected.

Perhaps the greatest single advantage VL contracts offer is the opportunity to move money within the policy from one earmarked account to another without incurring a taxable event. In other words, a VL contract with a common stock and money market account allows the policyholder to protect gains in changing markets without taxation. An example:

This time Mr. Smith owns a $100,000 variable life contract. The policy has a money market account, a common stock account and a general or fixed account. Since the economy was enjoying a bull market at the time of purchase, Mr. Smith elected to place all of his policy cash value into the common stock account.

Mr. Smith realized a 45% increase in cash value over the past 18 months but now the economy is becoming more uncertain. Interest rates appear to be headed up and the stock market down. By switching his cash value from the common stock to the money market account, Mr. Smith may accomplish two things:

(1) he protects his 45% gain and

(2) he will enjoy conservative but increasing money market account gains in a rising interest rate market. And, perhaps best of all, this switching of funds causes no taxable event.

If Mr. Smith had invested money into a common stock mutual fund that earned 45% gains and wanted to then shift to a money market account outside of a family of funds, the entire 45% gain would be income and therefore taxable. Although the variable life contract is decidedly more risky than other life insurance instruments, it does offer exceptional potential for gain (or loss) to the sophisticated or adventuresome investor.

The example above illustrates the **"conduit theory of taxation",** as it has been called. While the investment company makes decisions which lead to greater returns and even capital gains, policyholders bear no responsibility to pay income taxes until such time as a benefit is actually paid. All income accumulates on a tax deferred basis until it is paid or attributed to the policyowner. Therefore the investment company acts as only a conduit, or transfer source, through which taxation eventually flows to the rightful owner of the income.

Interest Sensitive Whole Life

Like traditional whole life, ISWL only allows access to existing cash values on a policy loan basis. There is no partial wash interest credit available and all money borrowed incurs a relatively stiff interest charge (usually from 7-14% on a variable scale depending upon current rates). Since the company cannot invest premium it no longer controls, they must assess the policyowner for this lost income by charging interest. In traditional whole life and ISWL, cash values are owned by the insurer until death of the insured, endowment or cash surrender ending the contract is elected

As the cash value of ISWL accumulates, it is sheltered from income taxes and the familiar concept of insurance policy loan rules apply to ISWL cash value loans. Any money borrowed is not taxable because the law protects such amounts from any income taxation. Insurance policy loans are not income taxable. Therefore, even if the amounts borrowed include income instead of only principal, there will be no income taxation.

Furthermore, the cash surrender of an ISWL in which the cash value amount exceeds the total contributions tendered will result in the current taxation of all income (amount over the total cost base of the policy). This taxation concept is the same as the long standing rule applying to the surrender of traditional whole life plans.

Single Premium Whole Life

Since the purchase of SPWL today constitutes the creation of a Modified Endowment Contract (see earlier discussion in Section I under "SINGLE PREMIUM WHOLE LIFE), extra precaution is necessary when marketing. The client must understand that such a purchase is based on the

assumption that cash values will not be withdrawn, borrowed, surrender, etc., until at least age 59 ½.
Any cash access prior to this age will result in the 10% tax penalty for early withdrawal in addition to customary current income taxation. Furthermore, any income removed after age 59-1/2 will be subject to ordinary income tax rates.

Today, the purchase of a SPWL policy is made by people who are looking for the combined benefit of proceeds (in the event of death) or supplemental retirement income at older ages (in the event a long life span is realized). The SPWL purchase is not used as a income tax avoidance mechanism as it was during the mid 1980's.

Interest credited to the SPWL policy account is allowed to accumulate free from income taxation, but cannot be removed without triggering a taxable event under the current "modified endowment" rule. The key to understanding is the current "double personality" approach. If the cash values and dividends remain in the policy, the contract is treated like any other regular life insurance. **However, if money is removed from the policy, the modified endowment rule says the contract is treated like an annuity with respect to income taxation (last-in, first-out).**

Although the taxation rule of modified endowment removed the Single Premium Whole Life Plan from the enviable status of being a tax-free savings account, contract owners who purchased the product before June 21, 1988 were allowed to retain the advantages as discussed in the previous Single Premium Whole Life section.

Individuals seeking to earn conservative rates of return in a tax sheltered manner, but who wish to have flexibility in retrieving money in case of unexpected emergency, should avoid the purchase of SPWL. Any insurance agent who does not accurately describe the potential drawback of a tax penalty is doing a disservice to the insurance purchasing public. It is also unwise for younger clients (under age 50, for example) to purchase substantial amounts of SPWL because of the MEC rules. The further away a person is from age 59 ½, the more likely it usually becomes for them to tap into policy cash values for some unforeseen reason. **A SPWL (or any MEC policy) contract is not unlike a diamond--** it should be considered forever (or at least until death do us part).

Annuity (Variable and Fixed)

Tax law changes of the 1980's sent a clear message to the insurance industry and insurance buying public of the basic purpose of annuity. Annuity is a long term investment, not a two or three year funding instrument. General knowledge about tax treatment of annuity during accumulation and liquidation periods is essential. The estate taxation implications of annuity are also important.

During the accumulation period of an annuity, the fund grows on a tax-deferred basis. Put another way, interest income is not includable as gross income to a contract owner until he or she actually participates in the liquidation of the fund by receiving annuity payments. Take a look at an example of the special use of an annuity in a qualified plan called a tax-shelter annuity (TSA).

IC Section 403(b)

An Overview of Tax Shelter Annuities

Since they are not employed by corporations eligible to set up Defined Benefit and Defined Contribution Retirement Plans, the IRS has traditionally allowed Employees of religious, charitable, educational, scientific, and literary organizations described in IC Sec 501(c)(3) or public school systems. (Public Law 87-370) to set up Tax Sheltered Annuities to provide for retirement. Beginning in 1997 most of these organizations werw also allowed to set up 401K plans as an alternative if they so desired.

CAN THE EMPLOYER MAKE CONTRIBUTIONS? –

Yes, but typically the employee agrees to have his or her salary reduced by the amount to be contributed. If the Employer contributes its own funds the arrangement is subject to the same rules that govern regular qualified plans.

HOW MUCH CAN BE CONTRIBUTED?

Generally follow the same guide lines as 40lk deferral limits i.e., $9,540/yr (indexed from 1997), and very special and complex rules relating to past service costs may permit larger employee contributions. In any case, a salary reduction agreement must be entered into **before the reduced amounts are earned.**

WHAT MAY THE FUNDS BE INVESTED IN? -

1. **Annuities** (fixed or variable and individual orgroup)

2 Retirement income or endowment **insurance policies**

3. **Custodial accounts** invested in **mutual funds**

4. Combination of **whole life insurance and annuities**

WHO IS THE CUSTODIAN OF THE ASSETS?

Annuities and insurance are with an insurance company. Mutual funds are placed with a corporate trustee.

WHEN IS A DISTRIBUTION REQUIRED?

Generally the funds are withdrawn at retirement. In order to avoid penalties, withdrawals must begin by April St. of the year following the calendar year during which the taxpayer became 70 ½ and, at a minimum, must be taken out over the life expectancy of the taxpayer and, if desired, his or her spouse.

CAN TSA FUNDS BE BORROWED? –

Participants **can borrow funds** from their TSA and later restore them without incurring a tax, **if established conditions are met** regarding maximum loan amount, amortization requirements, time period for repayments, etc.

WHAT IS THE PENALTY FOR EARLY WITHDRAWAL –

There is a 10% penalty for withdrawals prior to age 59 ½ and all withdrawals are taxed currently as ordinary income, unless the distribution is rolled-over, transferred to another TSA or the annuitant is totally disabled, separates from service (after age 55), or dies. Also, the salary reduction amount (but not the earnings) is available for financial hardship, e.g., an immediate and heavy financial need which cannot be met with other assets.

WHAT HAPPENS AT THE DEATH OF A TSA PARTICIPANT? –

The proceeds become a part of the taxable estate for Federal Estate Tax purposes and they are considered as ordinary income to the beneficiary, except for any "pure" insurance proceeds.

HOW DOES A PARTICIPANT CHANGE FROM ONE TSA TO ANOTHER? –

The transfer of funds from one 403(b) investment to another will not be considered a taxable distribution if the funds remain subject to any distribution restrictions on the prior investment. Revenue Ruling 90-24.

CAN THE DEFERRED AMOUNTS BE COUNTED AS CURRENT COMPENSATION IN COMPUTING BENEFITS UNDER A SEPARATE QUALIFIED PENSION PLAN? –

Yes, see Revenue Ruling 84-74, 1984-1 CB 118, and the Small Business Job Protection Act of 1996 which also extends this concept to the deferrals under 40lk and 457 programs.

OTHER TAX CONSIDERATIONS:

1. The employee avoids current income taxation on the deferred amount (except it is included in the Social Security base.)

2. The earnings on the accumulating funds are not taxed until they are distributed.

Non-qualified Annuities

Any contract that is effective or had contributions made after August 13, 1982 is treated in the following manner: paid dividends, cash withdrawals, loans or partial surrender amounts are ordinary income to the extent cash value exceeds the cost basis (total amount invested). The balance of these funds is considered a recovery of income and is therefore tax free. In other words, any interest earned within the annuity is deemed to be first out money and income taxable.

The old rule (pre-1982) was much more favorable because any withdrawal made prior to annuity starting dates was recovery of investment (first-in, first-out) and tax free. In this manner people could access their investment soon after establishing an annuity without tax consequences. Currently however, not only must annuities issued after 1982 meet this interest first rule, any taxable payment received after January 18, 1985 can also be hit with a 10% penalty.

The penalty does not apply if one of the following three conditions is met:

1.) if the payment received is from a qualified retirement plan;

2.) if a payment is made to an annuitant who is at least 59 ½ years old; or

3.) if the payment is of a periodic nature (over a lifetime)at least 60 months subsequent to the annuity starting date.

Clearly, short term withdrawal of the past have been eliminated by tax law changes of the early 1980's. The intent has to make annuity a long term investment vehicle and not a short term tax avoidance ploy. Attempts in the early 1990's to destroy all or part of what tax benefits remain to annuities were thwarted by a concerted lobbying effort of the insurance industry.

Annuity Payouts

Annuity payouts are taxed in the same manner as life insurance settlement options. Various options include interest only, fixed period option, fixed amount option or life settlement option. If the payment received is the result of interest only, then all of it is taxable. Options that make payments based on the liquidation of both principal and interest are more complex from a taxation standpoint. Liquidated payouts utilize the concept of "exclusion ratio". The actual investment in the contract (premium payments) is compared with the expected return under the contract (using mortality projections of life expectancy) The ratio, or percentage, that results is then multiplied against the payment amount to determine how much is excluded from taxation. Recovery of cost basis occurs based on the life expectancy of the annuitant. Generally, the expected return equals the total amount the annuitant is expected to receive under the contract according to contractual guarantees. Both fixed amount and fixed period payout options are taxed in the same manner.

The life income option is identical to the life income settlement option (available under a life insurance contract) with this exception:

- In order to determine life expectancy under annuity, special IRS tables and not insurance company mortality information must be used.

For estate taxation purposes, annuities may or may not be includable. If the person who died (decedent) was receiving annuity payments that stopped at his death, nothing is included in the estate. However, if the annuity had a refund or guaranteed remaining income feature, the present value of those payments remaining for another person might be included in the estate.

A **premium payment test** is used to determine survivor benefits which may be includable in the estate. If the decedent paid none of the premium for the annuity, then none of the value is included. If some percentage or all of the cost was paid by the decedent, then that percentage is applied in calculating the amount included in the estate.

Also, the cash value of an accumulating fund is includable to the extent the decedent contributed toward its purchase. One final point: since 1984, the value of any qualified retirement annuity is considered a part of the gross estate. Before 1984, a maximum of $100,000 was excludable.

MISCELLANEOUS INSURANCE TAXATION CONCEPTS:

GRANDFATHERING AND PLANNING FOR FEDERAL ESTATE TAXATION

Another critical area regarding taxation and interest sensitive insurance products is their role in estate planning. The other concept to be discussed is the impact of past and potential future tax reforms.

Generally, estate planning is the protection of an existing estate from transfer cost and reduction of that estate when passing property from one party to another. With proper planning some transfer costs can be eliminated or significantly reduced. Those costs that remain can be paid from the assets of the estate, thus diminishing its size. Alternatively, proper amounts of life insurance can be purchased in order to preserve the original size of the estate.

Estate planning can be a time consuming process, depending upon the size of the estate. Normally, a client should bring together an attorney, a tax professional and an insurance professional for most necessary technical advice. Since the proceeds of life insurance pass outside of the probate process when a beneficiary has been named, they can quickly be used to pay transfer charges. This allows a more orderly and immediate transfer of estate assets. Additionally, the proceeds from life insurance are free from income taxation. However, the life insurance proceeds will generally be includable in the estate and inflate its size for valuation purposes.

The other important miscellaneous aspect of taxation to consider is past and possible future tax reform. The favored tax status enjoyed by the products we have analyzed is not indefinitely guaranteed. The IRS code can be changed at any time by the United States congress. The tax man is always looking for ways to raise revenue and insurance products remain one of the strongest bastions of resistance. What will happen to the status of insurance products from a tax standpoint in the future? How soon could significant changes be made that would affect millions of Americans? Of course, no one knows the answer until change is proposed and subsequently enacted.

One result of past tax reform has been the notion of "grandfathering". To grandfather means to enforce new rules as of a certain date and leave alone anyone who relied on past rules in a decision already made. For instance, changes in the tax treatment of annuities affect people differently depending if they were purchased before or after 1982. In the example of IRA. Tax reform of 1986 took away IRA's from millions of Americans but whatever had already been in place prior to reform is unaffected. Again the 1997 changes to the IRA illustrate this point.

Although past results do not guarantee future actions, they are all we have for guidance. Therefore the best advice may be to tell clients to act now before important benefits are taken away from consideration. People tend not to act when something is available but as soon as it is removed, protests become too loud, too late.

Estate Taxation of Annuities (IRC Section 2039)

A general definition of annuity is the concept of periodic payments over a set time (e.g., life annuity with named beneficiary). A decedent's gross estate will include the present value of an annuity receivable by a beneficiary as a result of surviving the decedent.

Annuity is included in the gross estate when payable to decedent in any of the following ways:

1) For life, then payable to beneficiary

2) For a period that did not end before death

3) For a period ascertainable only with reference to date of death

If the annuity ends, at the decedent's death, annuity is not includable if payments to a beneficiary are not provided afterward. A key factor: Whether or not the decedent had an enforceable right to receive payments from the plan during his lifetime.

Five annuities includable in the gross estate:

1) Contract under which decedent received or was entitled to receive annuity or other payment immediately before death and for duration of life with stipulation that payments continue to beneficiary after decedent's death

2) Contract under which decedent received payments prior to death together with another person for joint lives with the stipulation that payments continue to survivor after death of other individual (i.e., joint and survivor annuity).

3) Contract between decedent and employer under which decedent received or was entitled to receive annuity or other payment after retirement for life with payments to beneficiary upon death.

4) Contract between decedent and employer that provided for an annuity or other payments to surviving beneficiary if decedent died prior to retirement or before expiration of a certain time.

5) Contract under which decedent was receiving or was entitled to receive an annuity or other payment for a specified time period immediately before death with payments to continue to named beneficiary if decedent died before time expiration.

ESTATE TAXATION OF LIFE INSURANCE

Life insurance proceeds are included in the estate for tax purposes if:

1) the decedent had incidents of ownership in policy

2) proceeds are paid to the estate

3) proceeds are received by another for benefit of the estate (e.g., received by personal representative to pay estate taxes)

The treatment of a decedent's life insurance on the life of another (e.g., wife insurance; partnership cross-purchase buy-sell agreement policy; children's insurance):

Valued at replacement value (normally the CSV).
Included in the estate as an asset rather than as insurance.

Incidents of ownership: Rights of insured or insured's estate to economic benefits of policy. Incidents of ownership include the right to:

1) Name/change beneficiaries.

2) Assign the policy.

3) Revoke as assignment.

4) Surrender/cancel policy.

5) Pledge policy for a loan.

6) Get loan or surrender value of policy.

7) Change beneficiary on a policy owned by closely held corporation.

8) Purchase policy purchased by employer.

9) Change ownership, benefits, proceeds in policy owned by a trust.

10) Deal with policy even after policy is physically transferred.

11) Control policy owner.

12) Retain reversionary interest worth more than 5% of policy value.

Proceeds payable to or used for benefit of the estate is defined as: any life insurance receivable by the estate, the executor or anyone empowered to act for the estate can be included, even if purchased and controlled by someone else during the decedent's lifetime. If they are used to pay estate taxes, life insurance proceeds enter the estate.

Group life insurance rules:

1)Included in decedent's estate if decedent had the "right to"

a) Change beneficiaries.
b) Terminate policy.
c) Prevent cancellation of contract by purchasing policy.

2) The group life contract is not included (no incidents of ownership) if:

a) Power to terminate policy is limited to terminating employment.

b)Right to convert group policy to individual policy at end of employment is assigned to another.

The term **"incidents of ownership"** does not apply to proceeds of a life insurance policy received by inheritance through the estate of another.

Life insurance proceeds do not qualify for the marital deduction if life insurance is payable to the surviving spouse but is not in the decedent's gross estate (i.e., no incidents of ownership). Transfers of life insurance within three years of death are included in gross estate as gratuitous transfers.

ASSET EVALUATION

The valuation of assets is crucial to the estate planning process because it is necessary in determining the potential liquidity needs of the estate executor, realizing the maximum benefit from a strategy of lifetime gifting and arranging a possible buy-sell agreement. It is a fact of estate planning that the lowest value is not always the most beneficial.

In order to accurately calculate the federal estate (and state death) tax liability, the value of the decedent's estate must be determined with precision. Each person, during his life, accumulates assets in a unique combination. The assets are of different types. Those different types of assets are valued by different methods for purposes of determining the value of the taxable estate.

In most cases, *fair market value* is used to identify the value of assets. For some types, such as listed securities, valuation is not difficult. For others, however, such as closely held shares, the problem of accurate valuation is considerably more demanding. The general valuation rules of the IRS value assets at "fair market value" of the value a willing buyer would pay a willing seller, neither being desperate to buy or sell and both aware of the relevant factors. The factors examined by the IRS include the frequency of sales, the relationship between the buyer and seller and existing options to buy and sell.

For fair market value determination, the date of death or the **alternative valuation date** (defined in IRC, Section 2032 to be six month after the date of death).

Examples of valuation methods applied to different types of assets follow.

TABLE 6
Asset Valuation Methods

Asset	**Method**
Publicly traded securities	Average of the spread between the high and low on the valuation date.
Mutual Funds	Redemption value which shareholder would receive if shares were redeemed on the valuation date.
Real Property	Fair market value as determined by licensed appraisal.
Mortgages/ Notes	Amount of unpaid principal plus Payable accrued interest.

Type of Asset	**Method**
Life insurance	If on decedent's life, the face amount payable to the named beneficiary or the estate, if decedent has incidents of ownership. If on life of third person, replacement value.
Closely held	Value is determined by shares taking into account book value, outlook for the business, goodwill, and any recent stock sales or issue prices. Accuracy is very difficult!
Property held in joint tenancy	If held with spouse, one-half the value of the property. If held with an unrelated person, the entire value.

The Three Year Rule of IRC Section 2035

The 1976 Tax Reform Act stated that the value of all transfers made within three years of death are includable in the gross estate. In 1981 a rule amendment said that gifts made within three years of death are not included in the gross estate for decedents dying after December 31, 1981 with five exceptions, with the following exception pertaining to the life insurance contract:

Transfers by the insured of life insurance policies within 3 years are includable in the gross estate at full value of the proceeds whether or not a gift tax return was required, EXCEPT: premiums paid or deemed paid within three years of death, to the extent that the payments would not have caused policy proceeds to be included in the gross estate under prior law, are not included.

STUDY GUIDE SECTION II

SECTION II
FEDERAL TAXATION AND ADVANTAGES

(COMPLETING THIS SECTION IS ENTIRELY OPTIONAL.)

The following short answer essay Questions are designed to help you:

1) learn the preceding material more thoroughly and

2) enable you to more easily take and complete the assigned 100 question multiple choice exam.

All essay questions follow the written text in the exact order in which it is presented. Answer in the space provided or on separate sheets of paper.

QUESTIONS 1 & 2
PERTAIN TO "QUALIFIED MARKETS"

1) What separates a "qualified plan" from a "non-qualified plan"?

2) Describe the purpose of an IRA and list one advantage and one disadvantage.

QUESTIONS 3 & 4

REFER TO "NON-QUALIFIED MARKETS"

3) What is the main reason an individual would participate in a "non-qualified plan?"

4) When, if ever, are income taxes due from the income generated in a non-qualified plan?

QUESTIONS 5-11

PERTAIN TO "UNIVERSAL Life"

5) What type of income taxation governs the cash accumulation in a Universal Life policy account?

6) Explain the LIFO (last-in, first-out) tax application and why it is important to accessing the cash values in a UL policy.

7) What is the main tax advantage to using a partial wash loan to borrow UL cash values?

8) Since policy account values in a UL contract technically belong to the policyowner as opposed to the insurance company, why should the policyowner want to pay any interest charges when removing cash from a UL policy account?

9) After money has been borrowed or withdrawn from a UL policy, should future payments of money by the policyowner to the insurance company be earmarked as new premium, loan repayment or replacement of withdrawn funds? Why?

10) What is the significance of IRC section 7702 as it pertains to policyowners who wish to remove cash from UL policy accounts?

11) What tax advantage does a Single Premium UL contract taken with an Option 2 death benefit hold for wealthy clients?

QUESTIONS 12-14

REFER TO "VARIABLE LIFE"

12) Under a Variable Life policy, what is the general tax rule regarding the transfer of cash funds from one policy account to another within the insurance policy?

13) Give an example of the type of economic condition which makes funds transfer between policy accounts without income taxation such an important concept to the marketability of the VL contract.

14) Explain the conduit theory of taxation of the Variable Life contract.

QUESTIONS 15-17

PERTAIN TO "INTEREST SENSITIVE WHOLE LIFE"

15) Can the wash loan concept be effectively used to borrow money from existing cash values in an ISWL policy? Why or why not?

16) How is the cash accumulation in an ISWL policy treated from an income tax stand point?

17) In what manner is the cash surrender of an ISWL policy similar to that of traditional whole life?

QUESTIONS 18-20

REFER TO "SINGLE PREMIUM WHOLE LIFE"

18) What are the income taxation principles concerning the removal of cash from a SPWL policy purchased prior to June 21, 1988?

19) What are the income taxation principles concerning the removal of cash from a SPWL policy purchased as of June 21, 1988 and thereafter?

20) If cash value is removed from a SPWL policy, what are the income tax implications if the policyowner is 55 years of age versus 60 years of age when the removal is activated?

QUESTIONS 21-23
REFER TO "ANNUITY"

21) List the ways in which annuity income taxation today differs from annuity income taxation prior to 1982.

22) List the three ways that a 10% income tax penalty is avoided when annuity cash withdrawal is activated.

23) Of what value to an annuitant is the exclusion ratio?

QUESTIONS 24-26
PERTAIN TO "MISCELLANEOUS CONCEPTS"

24) Discuss the concept of "the high cost of dying" and why life insurance proceeds are beneficial from a taxation consideration.

25) Explain the concept of "grandfathering" as it relates to the legislative process.

26) Why is it unwise to completely rely on the prospect of grandfathering in the face of potential sweeping tax reform in the future?

QUESTIONS 27 & 28
PERTAIN TO "ESTATE TAXATION OF ANNUITIES

27) List three ways an annuity is paid into the gross estate

28) List two annuity contracts that are includable in the gross estate

QUESTIONS 29-31
PERTAIN TO "ESTATE TAXATION OF LIFE INSURANCE"

29) What are three circumstances under which proceeds are included in the estate for tax purposes.

30) What does incidents of ownership mean? List four examples

QUESTIONS 32-34
PERTAIN TO "ASSET VALUATION"

32) Why is valuation of assets important to the estate planning process

33) Valuation of assets can potentially be fixed at two points in time. What are they?

34) How is life insurance valued as an asset at death?

PART III: MARKETING INTEREST SENSITIVE INSURANCE PRODUCTS

The intent of this section is to bring into focus the products discussed from a marketing viewpoint. The most likely market for universal life is not a retired person and variable life is not a good product for conservative people who can not afford to risk any capital. Knowing which products are best suited to particular marketing prospects is fundamental knowledge for anyone with an insurance producer's license.

Before discussing specific market potentials of the various contracts, **a brief discussion of "marketing"** is essential. Simply put**, the science of marketing can be reduced to identifying a need and then satisfying that need.** How easy it is for the new insurance agent to lose focus and begin a career by trying to be all things to all people. Successful businesses did not get that way by haphazardly selling everything imaginable to anyone who might buy! There is no reason for a professional insurance representative to also fall into such a trap.

The concept of **"target marketing"** is a simple yet often ignored selling principle. By exercising total control over:

1) deciding what product or company(is) you shall represent; and

2) deciding to whom you will market these products.

It is the producer/agent who can dictate the formation of his or her own business. The sooner the agent understands that he is in business for himself, the earlier success will arrive. There is no need to be at the whim of consumers who are fickle and indecisive. Nowhere is there a law mandating that new agents must tolerate excessive abuse and earn tiny rewards. Taking charge and controlling your own fate plays an enormous role in your ultimate success. The more definite you become in setting your goals and priorities, the more prospects will respect your expertise and guidance. Nobody is happy when they deal with a salesperson who seems wishy-washy or unknowledgeable. **As the adage says "plan your work and then work your plan."**

If you are deeply interested in health insurance products instead of life contracts, then emphasize them in your product portfolio. If you decide that helping senior citizens to understand Medicare supplements is most rewarding for you, then stop talking to young newlyweds about term insurance. The next few areas of retirement planning, tuition planning and business insurance are very briefly discussed as market segments. However, perhaps no greater opportunity exists in the near term than those associated with retirement planning. Over 70 million Americans alive today will be retiring over the during the years 2000 - 2030. Learning as much as you can about the retirement planning process and becoming recognized as a knowledgeable person in this area will assure your future career success.

Retirement Planning and IRA

The annuity and variable annuity products are the dominant insurance contracts used to fund retirement plans. The tax treatments they enjoy make their usage an excellent choice for both qualified and nonqualified markets. IRA rollover into a selected form of annuity is a viable alternative to traditional individual retirement accounts.

Basic knowledge of current and past tax laws regarding the IRA is required. More detailed information can be found in the previous section which discussed IRA. The producer must be aware of who is qualified for IRA and who is not. Income limitations and deductibility taxation information must be common knowledge to the professional retirement planner.

When approaching prospects for retirement planning, knowledge of eligibility requirements is crucial. For example, if you place someone into a qualified plan who doesn't qualify, you are open to malpractice because the client will incur unexpected tax liabilities.

What about placing extra dollars into retirement planning? There are many nonqualified products available for people to augment retirement income significantly above the levels available solely through qualified plans. Regular or variable annuities both offer tax deferred accumulation. A simple example of the difference between accumulation funds left to grow tax free versus taxed annually follows:

Mr. Smith has plans to invest $2,000 annually to help add to his eventual retirement. He wants to see the difference between an 8% annual return that is taxed compared with tax deferred accumulation. He is in a 30% tax bracket.

END OF YEAR	$2,000 invested annually at 8% no taxation.	$2,000 invested annually at 8% 30% taxation.
1	$ 2,160	$ 2,112
2	4,493	4,342
3	7,012	6,697
4	9,734	9,184
5	12,672	11,810

At the end of just five years, there is already an $862 advantage to tax deferred accumulation. The difference grows each additional year.

Tuition Planning

Helping families plan for future tuition payments can be both a challenging and rewarding experience. Many of the products we discussed could play a role in tuition accumulation, but as a practical matter universal and variable life would be preferred. Whether universal or variable life is selected will largely be based on the attitudes of the parents involved. More sophisticated and less conservative parents may choose Variable Life while more conservative people will like Universal Life.

Universal and Variable Life are adaptable for tuition accumulation for two basic reasons:

#1 tuition money will be available whether or not a parent or parents remain living; and

#2 the policy account accumulates on a tax deferred basis.

Once again tax reform has made it more difficult to save money for tuition through traditional methods. Before 1986, parents could shift money into a taxable account under the child's name and the income tax rate payable was at the child's rate. Today, any interest in excess of relatively meager amounts earned in the name of a child, who is under age 14, is taxed at the rate of the parent.

Single Premium Whole Life could also be used for tuition accumulation but it does have drawbacks. The first problem for most parents is a lack of large amounts of cash to plunk down. Perhaps well financed grandparents might be willing to provide a one time cash outlay of from $5,000 to $10,000. Of course, the second disadvantage could be the potential 10% tax penalty and current tax treatment as an annuity for amounts withdrawn according to the modified endowment rule.

It is also essential to determine whether or not the prospect even has a tuition planning mentality. Ask questions. If the prospect does not believe in the value of education or feels their children should earn their own way, then you may waste your valuable time in suggesting a great idea for tuition planning. Avoid, at all costs, the pitfall of reading your own beliefs or prejudices into helping clients establish a financial plan.

Business Insurance

Universal Life is an excellent interest sensitive product for buy and sell agreements and keyman protection. The cost of the actual protection is inexpensive at younger ages (under age 50) and the flexible premium is a real plus to business because cash flow may sometimes be erratic. Other advantages include the fact that the cash values of such policies are an asset and may be withdrawn or borrowed against in times of financial emergency.

Briefly, a buy and sell agreement can involve the use of life insurance as protection against the premature death of business partners or shareholders in a closely held corporation. Example: partner A owns $200,000 of life insurance on partner B and vice versa. Each partner agrees that the $200,000 is the buyout price for the other's business ownership in the event of premature death.

A keyman situation exists in a business where an employee is so critical to the operation of the business that his premature death would seriously affect the ongoing viability of the firm. The firm buys life insurance on the keyman (or woman) in the event of premature death. This assures funds are available for the company to continue operation as it seeks to replace the valued services of the deceased key person.

Helping small business owners with their insurance programs tends to be an extremely lucrative but initially frustrating experience. Building the level of rapport and trust necessary to deal profitably in this arena can be time consuming and relatively unrewarding at first. Until a few business owners take a chance with you and are satisfied with your level of service, success is elusive. Prove yourself in the long term and you will likely have more business than you can handle. However, if you perform poorly, your name can become mud faster than the speed of light.

Marketing According to Age Group

Juvenile Markets. Since no one under the age of 15 may directly purchase a life insurance contract, the marketing is to parents or grandparents. Purchasing life insurance on the life of minors is a good idea from two basic points of view: cost is very low and can be locked in early and potential final (burial) expenses are covered. The best product to use depends on many factors. Some professional insurance marketing groups are split on the idea of broad coverages being sold to minors, especially with the use of permanent insurance. The argument against broad use is that the financial resources should instead be placed on the lives of the family wage earners (the parents) instead of being applied to the lives of the children. Obviously, if family resources are severely limited, scarce premium dollars are more effectively spent on protecting the lives of the wage earners. Perhaps an inexpensive term rider can be added to a parent's policy to provide basic coverage on any minors. Again, looking to grandparents who are financially secure may offer the best solution to this particular dilemma.

Family Markets (20-45 year Olds).

Of all products discussed, perhaps none better suits the needs of this market than Universal Life. The following example illustrates this point:

Jim Jones (no relation to the Jonestown founder) is 22 years old and was just graduated from college. He will be wed in six months. He purchases a Universal Life policy with a $100,000 death benefit and pays the minimum premium possible. When he gets married he adds his wife to his policy with a $50,000 term rider. They purchase a home in three years and have an $80,000 mortgage.

Jim increases his policy face amount to $150,000 and pays full premiums into the plan to take advantage of tax-deferred savings while his wife is still working. At age thirty Jim is now the father of twin girls and his wife will be out of the workforce for five years. Money is tighter now and Jim increases coverage to $250,000 in the same policy but pays no premiums for several years, allowing the policy account that was built-up to pay the insurance costs.

Once Mrs. Jones re-enters the work force, maximum amounts of premium deposit are made into the policy to help with future college tuition costs. While the twins are at college, the Jones' withdraw and borrow from the policy account to help offset tuition payments. After the girls are graduated and the mortgage is paid, Jim has less of a need for insurance protection and reduces his coverage to $100,000. He and his wife now make maximum premium payments to help supplement retirement.

The above example powerfully demonstrates the flexibility of Universal Life at so many stages in life that are common to many people. Could Variable Life be used in this example? To a certain extent yes, of course. Again it would depend on the basic investment attitude of the Jones': are they conservative or willing to accept risk? Furthermore, it is recommended that variable life products should be sold only after a more conservative or basic life foundation has already been laid.

In the example above, once they attain retirement age, the Jones' might want to place money into Single Premium Whole Life or an annuity product to help add to retirement income. These and other options will be available to them.

In approaching the family marketplace, several key factors are involved and they all center around changing needs. The amount of money available for protection purposes is essential to the type of plan recommended. Likewise, protecting income lost to premature death can make a fundamental difference to the lifestyle of remaining family members. Fund accumulation can easily center around projected tuition needs. One truism still holds regarding life insurance, perhaps more today than ever before: **it is the only financial instrument that definitely provides funds in the event you die too soon or live too long.**

The Age 46 and Over Markets.

The main concerns of this market will be estate planning as well as to achieve financial independence upon retirement. It is a good group to work with because they tend to have disposable income and they know they need help in financial planning areas.

The fixed and variable annuity products discussed would be attractive to individuals seeking to increase retirement funds. The other alternative is Single Premium Whole Life. Of course a main difference between these two alternatives is that SPWL has a death benefit and annuities do not. The other issue in evaluating differences is whether or not the individual involved is bothered by the concept of principal liquidation. In considering a retirement accumulation fund, both products will grow on a tax deferred basis.

How will a Variable Life or Universal Life product suit the needs of this group? Again this depends heavily on the investment philosophy of the prospects involved. Variable Life may well suit the needs of a sophisticated individual who is willing to take significant risk. On the other hand, Universal Life, due to its increasing rate structure, may not be the best product available. In many companies, a traditional Whole Life product may be a better value for consumers than Universal Life at older age groups.

In summary, the decision to market can be based on either need or age groups. Either alternative will ultimately be successful if the agent is focused and follows through on efforts which are goal oriented. Between the two options of need or age marketing, all marketing still boils down to the need. Age is a secondary concern when evaluated in conjunction with needs analysis.

Prospecting Reminders:
Insurance vs. Investments

Not Investments? Perhaps the most fascinating aspect of these interest sensitive products is their competitive edge in the investment marketplace. At the same time, with the exception of variable annuities and Variable Life, the interest sensitive products are not supposed to be marketed as investments. The reasons are both obvious and more subtle.

The most obvious reason for not saying Universal Life, Interest Sensitive Whole and Single Premium Whole Life are not investments is it's illegality under Illinois law. Extreme sensitivity from a statutory standpoint exists in making any statements that will obscure or hide the fact that a life insurance purchase is involved. These are technically life insurance products, therefore they are not investments!

These products not only provide a death benefit, but additional funds are allowed to accumulate sheltered from income taxation. On a long term basis, the rate of return will exceed those provided through a comparable conservative savings vehicle upon which income taxes must be paid.

A less obvious reason for not marketing such products as investments is the fear that Congress will someday destroy the tax preferred treatment they currently enjoy. Insurance company literature provided to agents is usually careful to admonish representatives not to market them as tax-deferred savings accounts. The TAMRA changes in 1988 regarding Modified Endowment Contracts illustrates legislative sensitivity to how life insurance contracts are designed and marketed.

Lead Techniques.

Three basic groups of prospects every producer can approach include family members and friends, referrals from current clients and making cold calls. Among all the people you know, there are varying levels of need and disposable income availability. If some ideas you have studied particularly strike you, develop an approach that utilizes your new knowledge. This can benefit you and a client. A systematic way to accomplish this:

- **Write down the names of everyone you know (label them as either current clients or as nonclients) on an index card (or refer back to the list you probably made when u first started in business).**

- **Divide the Names into "prospect" piles as follows:**

1) Families (ages 20-45)
2) Retirement Planning (over age 45)
3) Singles (ages 20-45)
4) Tuition Planning
5) Business Planning

- **Now, on each card write down one or two needs each prospect is likely to have.**

- **Next, write down a product or tax advantage that could effectively serve the needs you have identified.**

- **The last step is to contact everyone again because you have exciting information to share with them.**

The tax laws and products developed by your company mean tremendous advantages for them. You can show them how to use each dollar more wisely and effectively. If they likely need retirement planning, tuition planning or business insurance, it is a tremendous lost opportunity to both the agent and the client/prospect not to **make an hour or so available to discuss the matter further.**

EPILOGUE:
The New Generation of Product

Never before have insurance products fit the needs of the American consumer as well as today. Keen competition between companies assures the very best product and service available. If there is one major drawback it may be in the area of the public's awareness level or the general negative esteem in which “salespeople” are sometimes held (either rightly or wrongly so).

The insurance practitioner is not the only one not updating information. Millions of insurance consumers are visited but once or twice by an agent who either subsequently leaves the business or all but abandons the client. Since client needs change constantly and the conscientious agent reviews plans with clients at least one time per year. Not only does this convey the nonverbal message that there is concern for the individuals' financial well-being, the existing client base should be a hotbed of new sales and strong referrals.

Consumer surveys consistently indicate that a high percentage of the American public do not hold insurance professionals in high esteem. The past perception was, in some part, due to a general feeling that the interests of the agent were being served before that of the client. Through continuing education and constant product update, an opportunity to better serve the needs of the public is now available. Because of exciting new products, better trained sales representatives and greater dedication to service, everyone can profit.

NOTICE

THIS MATERIAL HAS BEEN PREPARED IN AS ACCURATE A MANNER AS POSSIBLE. HOWEVER, THE INTENT OF THE CONTENTS IS NOT TO PROVIDE A SUBSTITUTE FOR EXPERT OR PROFESSIONAL TAX ADVICE. IN THE EVENT YOU REQUIRE DETAILED, SPECIFIC AND ACCURATE TAX ADVICE, PLEASE CONSULT A TAX PROFESSIONAL AND DO NOT RELY UPON THE CONTENTS HEREIN.

THIS MATERIAL IS NOT INTENDED TO BE EITHER ACCOUNTING OR LEGAL ADVICE IN ANY MANNER WHATSOEVER. IT IS SOLELY DESIGNED AS A GENERAL INFORMATION AND LEARNING TOOL FOR INSURANCE PRODUCERS AND AGENTS WHO, IN ORDER TO COMPLY WITH STATE INSURANCE LAW PERTAINING TO LICENSING, MUST SATISFACTORILY COMPLETE PROPERLY CERTIFIED COURSE WORK.

STUDY GUIDE SECTION III

SECTION III
MARKETING INTEREST SENSITIVE INSURANCE PRODUCTS

(COMPLETING THIS SECTION IS ENTIRELY OPTIONAL.)

The following short answer essay Questions are designed to help you:

1) learn the preceding material more thoroughly and

2) enable you to more easily take and complete the assigned 100 question multiple choice exam.

All essay questions follow the written text in the exact order in which it is presented. Answer in the space provided or on separate sheets of paper.

The "STUDY GUIDE" to section III begins on the next page.

QUESTIONS 1-3
REFER TO : GENERAL MARKETING CONCEPTS AND INSURANCE PLANNING CONCEPTS

1) Discuss the ways in which the concept of target marketing can help an insurance agent to become a business success.

2) Why is the IRA such an important social device for retirement planning?

3) Discuss how the Universal Life contract can benefit individuals seeking to establish a tuition fund for children as well as the business owner who is establishing a buy and sell agreement.

QUESTIONS 4-8

PERTAIN TO : "AGE GROUP MARKETING, PROSPECTING, AND NEW PRODUCT AVAILABILITY"

4) Discuss how the flexibility of Universal Life can be useful in marketing it to family markets (20-45 year old consumers).

5) In applying you new knowledge, would a 50 year old insurance consumer probably prefer an ISWL contract, a Variable Life contract, a Universal Life contract or a Single Premium Whole Life Policy? Support your answer with logical analysis.

6) Why should insurance agents be aware of marketing insurance products as insurance and not as investments?

7) What are some lead generation techniques you may wish to implement in light of the insurance product revolution of the past decade?

8) Why does the new generation of life insurance products enable the insurance industry and it representatives to better serve the insurance consuming public?