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A Continuing Education Course

"Practical Financial Planning and the Role of Insurance"

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SECTION I: INTRODUCTION

The Importance of Setting and Achieving Goals

"Plans are nothing. Planning is everything."

- Dwight D. Eisenhower.

General Eisenhower knew a little something about the planning process. By the time that stormy day in June 1944 finally came when over one-half million allied forces and more than 5,000 battle ships slipped through the Strait of Gibraltar on their wayto liberate France, nearly two years of meticulous planning had already taken place.

His words ring true even when applied to the individual task of financial planning. Imagine if each individual dedicated themselves to 10 percent of the planning that Eisenhower espoused. Americans wouldn't have to worry about social security deficits and how company retirement plans will affect their future.

In most cases a "goal" is simply an arbitrarily selected result that has been predetermined, based upon some subjective desire. It is a point we place ahead of ourselves that we strive

to reach. Goals can be realized with proper planning. Without the planning element, goals are no more than wishes. Wishes are realized through luck or elements outside of individual control while goals are achieved through intelligent and thoughtful planning. A plan is something the individual can control and revise.

Goals are as unique as the people who set them. While everyone has goals, comparatively few people achieve or exceed them. Why is it, in America today, we have so much available in terms of opportunity and education yet 95% of our population retires to lifestyles ranging from poverty to mediocrity? **Who is to blame?** Is it the government's fault? How about the company employing us? Could it possibly be ourselves?

If goals are not established, then no thought is necessary for creating strategies. Setting goals forces you to plan if achievement has any chance. There are three basic choices: work toward achieving a goal, wander, or wander aimlessly. Goal settings, combined with plans put into action, are the only hopes for actual achievement.

The preceding statements can be applied to any type of goal setting. Our course of study will focus on the financial planning process. **The course title reads "Practical" Financial Planning because afford ability prevents most people from achieving "total" financial planning, even if "total" planning is actively desired**. Surrendering in despair because you cannot immediately do everything is nothing more than escapism. The old adage "How do you eat an elephant? One bite at a time" is appropriate.

Before discussing the basic process of financial planning itself, we need to lay some preliminary groundwork.

The Psychology of Financial Planning.

Proper financial planning is as much the psychological profiling of people as it is the technical application of product knowledge. If the mind of a client is not geared to the planning process, there is little to be done for them by even the best planner in the world. The basic working of the human mind is not easily generalized, given the basic fact that everyone is unique. Any individual is the product of the sum total of their own experiences, beliefs and perceptions. Offering financial advice to such a diverse population is a formidable task for all sales professionals.

Maslow's Hierarchy of Needs.

One famous psychologist of this century, A. H. Maslow, spent his life analyzing the manner in which human beings strive for the achievement of full potential. He called this the pursuit of self-actualization. However, before someone can achieve this highest level of self-fulfillment, many basic lower order needs must first be satisfied. This hierarchy demands the satisfaction of one level before the next can be attempted. From lowest to highest, these needs include:

1) Physical Needs. Food and water are necessary to sustain life. Without satisfaction of this primary need, little else is of interest to mankind. If you were, right now, very hungry and quite thirsty to the extent your life depended upon fulfillment, little else would matter to you.

2) Safety Needs. The demand for personal security or the freedom from constant fear of loss of life is a shared human concern. Without a sense of security, no person can strive for higher accomplishment. In thinking about this safety issue, it extends past physical boundaries into the emotional realm as well. If you are facing financial problems every waking moment, your fear is financial safety rather putting than dead bolt locks on your door.

3) Belonging/Love Needs. Human beings have a hunger for affection and a need to be accepted as social creatures by other human beings. This is the reason we have family get together, company picnics, bowling leagues, etc. Individuals need this sense of sharing and belonging.

4) Esteem Needs. People want prestige and recognition from others. Having other people respect our accomplishments can be an important determinant in whether or not we like ourselves. Have you ever had the boss you supported and encouraged you? Have you ever had this boss' evil twin? Anyone who constantly berates you, especially an authority figure (boss, teachers, parent, etc.), can leave life long scares.

5) Self-actualization. This highest rung on the ladder can be pursued with energy if, and only if, all of the previous points have been positively harmonized in the individual's life. This gives meaning to life. The feeling that you are accomplishing some important mission out of your unique talents and abilities allows you to reach even greater plateaus of accomplishment. Although self-actualization is the trophy we all seek, few of us will ever really be in competition, let alone win this coveted prize.

Defining Basic Terminology.

Human Psychology. Understanding the workings of the human mind is a challenge for even the greatest scientists making it their life's work. For purposes of financial planning, the skilled salesperson seeks to identify security needs which are of paramount importance to a client. The natural reaction of most people to unknown factors is to retreat to the familiar or to avoid completely. Therefore, discovering individual motivation can seem a time consuming and unrewarding task for even the most skilled financial counselors.

Financial Planning. What is Financial Planning? Who is qualified to do financial planning? These are important questions and the answers are not entirely clear cut. Financial planning is a multi step process whereby a complete data set is comprehensively reviewed, through a combined effort, resulting in effective problem solving.

Defining "financial planner" is much more elusive and inexact. These issues will be addressed in later sections of this manual.

The Planner Client Relationship

Establishing a comfortable line of communication must be considered the most important aspect of any relationship between human beings. The ability of one person to properly listen and correctly interpret the meaning of another is a rare social skill. **To "hear" another goes beyond the verbal and includes nonverbal indications which are sometimes more revealing.** Tightly folded arms and crossed legs can provide more information than words. The effective counselor is constantly aware of the possibility that **"what I say is not what I mean."**

Prior to one person revealing to another, intimate financial details or lifetime dreams, a foundation of trust must be established. **Winning trust in a limited time is difficult for even the most seasoned planner**. Without an appreciable degree of trust, effective and honest communication cannot be achieved. Without proper communication, financial planning will not be properly established.

One of the best techniques to build trust in a short period of time is through sharing information. In the real estate business, for example, trust might blossom as the local agent tells a neighbor what the house across the street just sold for.

In the financial business, it could be supplying information from reliable third party sources which will be beneficial in the decision making process.

Once the elements of trust and open communication have been hurdled, the main foundation for proper planning is in place. From this point however, success is by no means guaranteed. Many obstacles remain before both client and planner will accomplish any meaningful results. The hard work and patience of all parties are still prerequisites to success.

Understanding the "Salesperson" Perception.

What runs through the average American's mind when he or she hears the term "Salesman" or "Salesperson?"
Is it “oh, goody? This person is going to help me and make my life better off than before I met them?”

Unfortunately for those who sell for a living, studies show that salespeople are not looked upon very favorably. Most consumer anxiety stems from the basic perception that the salesperson's needs are served before those of the consumer. Everyone has heard horror stories of the slick talking salesman who makes money from the unsuspecting and fairly stupid prospect.

This is the shark versus the little fish syndrome. Consumers are little fish who must always be wary or they will be eaten financially by the fast talking salesman shark. The news is not good for sellers of insurance products when survey after survey places the used car salesman several rungs ahead of the insurance agent on the trust ladder.

Much of this resistance to the purchase of insurance and other financial products is due to their intangible nature. When one buys a car, even a bad one, one knows the purpose of the auto is getting them from one place to another, hopefully in some style and much to the envy of others. **But how do you show-off your life insurance purchase?** Rubbing it into the neighbor that hey, when you die, the family gets a cool half-a-mil free from taxes, may not bring out too many green-eyed monsters. To add an insult to injury, insurance is quite the complex financial product for most consumers to understand. **To most, an insurance purchase is little more than "a necessary evil."**

The human mind has a basic defense mechanism which prompts most people to initially say "NO" when approached as a sales prospect for any product or service, whether the product or service is truly beneficial or not. Piercing the

protective "NO" barrier in order to isolate real, rather than imagined objections, is the true challenge for the sales professional. Is the basic objection based upon fear and ignorance, or is it justified?

When it comes to the life insurance purchase, it is fear and ignorance much of the time. In fact, consumer studies in the recent past have concluded that 75%-85% of Americans consumers have either inadequate amounts or the incorrect type of life insurance coverage. This means, for as large as the life insurance industry is in America, 3/4 to 7/8 of Americans have a current life insurance need!

Obstacles to Sound Financial Planning

Educating the American public by weaning them from their own fear and ignorance is a formidable task. It has always been human nature to avoid the unknown in favor of the "safe and secure." The real tragedy may lie in the fact that before true safety and security is achieved, the demons of doubt and fear must first be laid to rest. This "Catch - 22" illustrates what President Franklin Delano Roosevelt meant when he said **"We have nothing to fear but fear itself."**

Before the American consumer can become financially educated, those who serve as financial consultants must also become proficient in their chosen field. Constant self-education is not only a commitment of any professional financial advisor, it is a lifetime requirement. If a consumer is to believe you, the sales professional, he must first be convinced your knowledge and expertise is truly valuable.

The "Good Planner": Taking Inventory

Three main factors, which are needed to become a "Good Planner," are:

1) Attitude
2) Technical Knowledge
3) Listening Skills

A good financial planner has a client-centered attitude. The client's financial needs are served before those of the planner. Secondly, the sound planner has acquired, and continues to learn, the technical expertise which is necessary to properly serve clients. Product knowledge, familiarity with basic taxation principles and the ability to accurately analyze will sound financial listening skills are arguably the most important elements in the financial planner's "toolbag."

Assuming the planner has these basic tools of success, he must then decide the marketplace in which to operate. Will he choose to practice in a single area of knowledge or decide to offer advice in a much broader arena?

Two basic approaches to financial planning are generalization and specialization. A specialist is devoted to solving problems in a single area, such as an insurance specialist. The generalist seeks to offer a comprehensive array of products and services which can encompass many areas simultaneously. More discussion about this topic appears in the next section.

The proceeding discussion was only an introduction to the concept of financial planning and its basic psychological implications. The course materials which follow address some specifics of financial planning, but a central focus is placed upon insurance products and how they relate to the entire process. The emphasis in the course title **of "Practical Financial Planning: The Role of Insurance" is on the word "Practical."** To assume everyone can afford to take all the steps necessary to assure financial success is ludicrous. It is the duty of the planner, whether specialist or generalist, to take a client's limited resources and to allocate them, on a priority basis, to best address the needs of the individual client involved. The aim of the course is threefold:

1) To provide the insurance producer with a strong sense of the process of financial planning; and

2) To provide the insurance producer with a review of basic insurance products and how they fit into the planning process;

3) To make the insurance producer more aware of the initial role he or she can fill in helping individuals and their families become more financially secure.

Section II: The Marketing of Insurance and the Financial Planning Process

There are five basic steps to the successful completion of any "planning process" and they include:

1) Prospecting
2) Information Gathering
3) Identifying Client Objectives
4) Discussing Recommendations and Plan Implementation
5) Regular Periodic Reviews and Subsequent Modification.

Our discussion will begin by generically discussing each of the above six steps and then relate them to insurance marketing principles.

1) Prospecting. There are many ways in which to prospect customers for the various lines of insurance. Basic prospecting techniques can include cold calling, direct mailing, obtaining referrals, contacting friends and family members and waiting for someone to contact you. One fundamental rule of prospecting is: **no matter how good you are, nothing will happen when you have NO ONE sitting before you.**

This first step is normally the most difficult for any budding insurance professional**. Poor prospecting is the single greatest reason for a failed sales career.** The typical path of the new agent is to solicit friends and family as clients. In a week or two, when these groups are exhausted (or begin to avoid the new agent like a dread disease), the agent must dig in and become ever more resourceful.

Engaging in the remaining five steps are entirely dependent upon the success of this first element of the planning process. The producer must always bear in mind that **virtually everyone has the need to transfer some financial risk from themselves to an insurance company**. Life, health, property and casualty insurance protects the average individual from the possibility of financial ruin for a relatively small cost.

Therefore, just about anyone has a need the insurance producer can satisfy. The main difficulty to be overcome is obtaining permission to meet with a prospect who is willing to listen and discuss his or her risk transfer needs. Once this first element has been satisfied, it is time to turn the second basic planning step.

2) Information Gathering

All details relevant to the clients' initial needs must be adequately collected by the planner. Items of information such as occupation, current salary, one or two income couple, number of children, assets, liabilities and information about the hopes, dreams and aspirations of the client are necessary.

The main data collection forms which are normally used in this step include a balance sheet, income statement and any other helpful financial statement. These information collection tools help the individual assess their current financial position. Although greater information collection normally translates into better planning, the degree of data collected does not have to be excessive to be helpful.

From the life and health insurance viewpoint, losses of income due to premature death or disability are the cornerstones of financial planning. Another basic risk transfer the individual client must evaluate is the long term care need. In analyzing property and casualty risk exposures possessions such as automobiles, home, furs, jewelry and any other special valuable items can be insured for a modest premium amount.

The basic question becomes: **"How much risk is the client willing to bear versus insurance premium costs?"**

The single greatest technique for exposing the life insurance needs, especially of a married couple with a child or children is to ask this question: "If you and/or your spouse were/was to die today, what should your life insurance benefits accomplish for your family?" Then the astute producer will shut up and await a response from one party or the other. The couple will often seem confused after this question is posed. The confusion stems more from the realization that not much consideration has been given to this important concern than it does from not understanding the role of life insurance as a primary income replacement tool.

When one of the couple speaks to this issue, it is often prefaced with the comment "we haven't really thought about it, before." That is exactly the point! Now they realize the importance of life insurance in protecting the future dreams of their loved ones, even if they are not there to share the experiences. Money is still needed to pay necessary expenses of everyday life.

The producer must have a ready pen because the couple will reveal what life insurance should do for them. They would want money for mortgage, car payments, tuition, keeping the survivors in the same lifestyle currently enjoyed and possibly many others. What have the client's just done? They have told the producer all the reasons for which they will buy life insurance. Why is this important?

The importance of this whole financial planning process lies in the way client needs are determined and then satisfied, especially from the role insurance purchase. In the past, the entire life insurance industry utilized the "traditional selling approach" to force life insurance on a reluctant public. For many hours wrestling matches would take place at kitchen tables across America as prospects were beaten down until they signed the application. Sometimes the insurance was purchased not for income replacement satisfaction, but just to get the pushy insurance agent out of their house. A very amusing game between cat and mouse, but hardly productive in the long term for either party.

Slowly, the new "nontraditional marketing" approach, embodied in the principles of the financial planning process, began to evolve and take hold. Insurance agents across the country began to realize that clubbing a prospect was not necessary.

This nontraditional method reverses the need awareness role. Instead of the agent convincing the prospect that they need life insurance because, it is the prospect who tells the agent why they need insurance. What brings this elegant yet simple transformation to life in the date and information gathering step? Instead of the planner telling the client what they need, the client reveals the facts and personal information which lead to identifying needs and objectives. The planner is no longer in the role of need convincer and is, instead, in the role of need satisfier.

Proper data collection can take much time, and the type of data that is to be collected depends heavily on the income level and net worth of the clients being counseled. People who have recently married generally do not have children or a mortgage. They have very limited insurance needs compared to people with high incomes who own considerable assets such as homes, boats, cars, stocks and investments. Before any analysis or recommendations can be made, collecting enough information is the critical concern. It is the job of the planner to make certain that enough information has been elicited from the clients in order to do a reputable job.

3) Identifying Client Objectives

A large portion of client need can be determined from the information collected by the planner. The skilled financial consultant will be able to quickly identify basic insurance needs and separate them from asset management or reallocation concerns. Once needs have been exposed due to the information collection process, they can be identified.

The determination of client objectives should naturally come from the client, and not be imposed by the planner. The personal beliefs of the planner must be separated from the needs expressed or stated by the client. Different people recognize different concerns, even when a set of facts may be similar. This means any two given people may not perceive something exactly in the same manner, in the same circumstances and, therefore, the personal prejudices of the planner have no place in the determination process.
For example: if the client has expressed a deep concern about providing all funds necessary for a child's education and the planner believes that children should take some responsibility upon themselves for paying tuition expenses, then the planner should listen and not invoke his or her own beliefs.

Listening skills play a key element at this point in determining what is important to the client once objectives have been expressed. For example, do the clients believe hospitalization insurance should cover first dollar amounts as well as high dollar amounts? The burden of interpretation falls upon the planner.

Another important element of determining client objectives is to separate the realistic from the unrealistic. Certainly, everyone would love to experience a high flying retirement yet still currently enjoy the short term pleasures of lofty living. With rare exception, these two masters cannot both be served.

Some short run considerations must be sacrificed for the long run and while some long term considerations are normally tempered by short term needs for available resources. Prioritizing client objectives and matching them with available current resources is a necessary and difficult task.

There are several rules that should be followed to properly set objectives. They should be as explicit as possible as opposed to being vague or dimly defined. By giving great thought to definition, important objectives are less likely to be overlooked. Detailed objectives also can lead to illuminating solutions which would otherwise be ignored.

The most important result of clearly identified objectives is that they lay the groundwork for selection the proper action which leads to the realization of the goals presented.

The main financial planning objectives typically encountered by individuals include:

- Premature death and income replacement
- Disability and loss on working income
- Medical expense needs to be met
- Liability Losses
- Property Losses
- Needs brought on by physical or mental incapacity
- Long Term Care needs
- Meeting capital accumulation needs
    - an emergency fund
    - an education fund
    - an investment fund
    - a retirement fund
- Reducing Taxation

Organizing information and then analyzing it to reveal which critical needs must be addressed for a particular individual in a specific order is the challenge of this step.

4) Discussing Recommendations and Plan Implementation

This is the step at which technical knowledge plays a key role. Since the client has told the planner, by this time, which future concerns are most important to him or her, the planner should now be in a position to make appropriate recommendations that will help achieve the stated goals. Take an example where a couple, who are homeowners, both work. They have three children and earn a gross income in the neighborhood of $75,000 a year. They have little savings and essentially spend every dollar made.

Their concerns, as expressed to you, were to pay off their $100,000 mortgage in the event of premature death to either wage earner and to make certain that each of their three children (who will be of college age in 9-12 years) will be able to pay tuition despite a premature death. From a life insurance point of view, they have expressed the concern that they want enough money to be able to keep either the husband or wife in their home after the other dies and still be able to send all three of their children to college.

If they expressed the attitude to you that saving was not a critical concern to them at this point and they enjoyed their lifestyle too much to sacrifice by putting money away for the future, then they have made something this point quite clearly: "we are interested in a death benefit, but not in saving money." If they were adamant about this belief yet you were concerned that they should still be saving money for the future, and you make all your recommendations with that in mind, you have violated the concept of listening.

You may be perfectly right, they should be saving for the future, but they have indicated to you this is <u>not what they want to do</u>. As the planner, you can express your concerns over their inability and lack of desire to save for tomorrow and at the same time realize that you have an obligation to satisfy the need that was expressed: a large amount death benefit at a low cost. Achievement of one of two goals is better than ignoring everything.

Many examples could be provided. The basic point is still quite simple: You must listen before you can recommend.

Once a client situation has been properly analyzed, understood and the proper objectives set forth, a list of recommendations to meet those objectives can be made and reviewed with the client. **By reviewing the needs that the clients expressed initially, and by having them reaffirm those needs through discussion, products can now be recommended that will address specifically those concerns expressed.**

The recommendations made may be quite expensive to implement and the ability of the client to afford them may be in doubt. At this point, returning to the priorities indicated in during the first visit, when needs were originally determined nd order of importance was listed, is recommended. **Available funds must be used to meet the most critical concerns first, followed by addressing other less critical areas, if funding is still available**. In discussing the recommendations with your clients, it is the role of the planner to be more like that of a counselor or advisor and less like a salesperson.

Selling without regard to the needs or expressed concerns of a client will not pave the way for long term success in any business. Serving satisfied customers, who will recommend the planner to family and friends because they felt comfortable and confident in the planner's hands, will assure a longevity in the financial need satisfaction business.

5) Regular Periodic Reviews and Subsequent Modification

The planner who successfully completes the first four steps has
a new client and a higher income. However, the obligation of the planner has not ended. It has just begun. Client circumstances can change dramatically and quickly in the fast paced society people live in today. Regular review, on at least an annual basis, is desirable. When the needs or circumstances of clients have changed, an adjustment or modification to the financial plan should be made to address the shifting concerns or needs.

The main idea: nothing is written in stone. The tendency for some practitioners to make a sale and then never call upon, or contact, the client again for several years is not good business and it is of little ongoing benefit to the customer. If needs have changed over a long period of time and a planner has not addressed or discussed the changes with the client, then any resulting shortage it is the fault of the planner - not the client.

For instance: Client X took out $200,000 of term insurance several years ago, his income has doubled, and he bought a new home worth three times as much money.

It should be obvious that the initial death benefit purchased will no longer meet the need for which it was originally intended. **Clients usually do not have day-to-day consciousness about their insurance protection shortage**. Had the planner kept track of the client's success through periodic reviews, modifications would have been made as they were necessary.

To avoid this follow through pitfall, the planner and client need to make arrangements for periodic review as a necessary part of the ongoing planning process. It should be much easier in the future for the planner to help address the changing needs of existing clients then it was for the planner to arrange the initial meeting. It is imperative to the long term financial success of the planner and client alike to engage in subsequent plan revision.

These five steps to generic financial planning may be utilized for single planning purposes as well as a multifaceted approach. In reviewing and studying the steps, they only seem like a basic common sense approach. The simple truth remains that, until fairly recently, their systematic application was rare.

Awareness of The General Versus the Specific

The General. This represents a goal of a planner or firm to offer comprehensive financial planning. Factors such as taxation, insurance and investment are all considered in this approach. Four characteristics to this approach include:

1) a professionalism toward the client in providing service;
2) the probable utilization and expertise of many professionals to solve client problems;
3) the production of a financial plan which is custom made and aimed directly at the objectives of a client; and
4) taking into account the total personal and financial situation of a client.

A "**team" approach is sometimes used for comprehensive financial planning.** Members of this team can include an attorney (needed to draft any required legal documents), accountants (for advice related to taxation), a trust officer, an investment advisor and an insurance expert.

The drawback of the team approach is the difficulty in coordinating the efforts of several professionals who may be pulling in different directions rather than working as a team, in harmony, for the benefit of the client. **However, to utilize only one professional in a comprehensive planning approach may be equally arduous because few individuals have the necessary credentials to simultaneously function intelligently in varying fields.**

The Specific. A limited purpose or single need satisfaction is addressed under the specific approach. An insurance professional may concentrate her efforts in the single area of life or health insurance, for instance. **The drawback of a single approach: while the client may have a need in many areas, only one area is being addressed without regard to the consideration of an overall integrated plan.** An advantage of a single purpose planning approach can be the utilization of an individual professional who is an expert in that area.

SECTION III
Consumer priorities and Planning Preferences

If you were to study the financial planning priorities of a typical group of Americans, you would find some very definitely held preferences. What are the main concerns of the "average" American? Time after time the survey reveals, in order of priority, they include:

1) Income and estate taxation minimization
2) Keeping pace with inflation
3) Accumulating funds for retirement
4) Insurance and risk transfer
5) Fringe benefits from employment

No matter what financial service you market, you must take the above list into consideration. The insurance professional may only address his own field, when consulting with a client, without considering any other financial priority. To be overly protected in one area while being subject to weaknesses in others defeats the basic purpose of overall financial planning.

1) Income and Estate Taxation Minimization.

Minimizing income taxes is essential to long term individual financial well-being simply because the more you keep, **the more you can invest.** By sharing a higher and higher percentage of your income with various governmental agencies, you must survive with the remaining sum of money. By intelligently planning and taking advantage of current tax laws, you will be able to keep, over time, substantially more money than you would have had with no planning taken place.

One of the most fundamental concepts in minimizing income taxes is to save money in some type of tax-sheltered vehicle. Tax-sheltered investments, such as an annuity, are viewed with **one major drawback** in most consumers' mind: since funds cannot be utilized until age 59 ½ without substantial taxation and penalties, they don't seem very attractive.

Recent studies show the average American saves less than most people in other industrialized nations in the world. However, with the "baby boomer" generation approaching retirement age, many experts predict a dramatic rise in savings. Disposable Income (for those personally unfamiliar with the

concept, disposable income is that money left which is left over at the end of the month when all the bills have been paid) which is invested tends to be placed in very conservative fixed rates of return devices which are easily accessible. **Are the majority of Americans sacrificing long term higher returns for short term access to their cash?**

Estate taxation minimization is another major concern to many Americans. Under 1997 tax law, estates valued at less than $600,000 at the time of death do not even require a filing with the government. Most Americans will never have an estate taxation concern at this level. However, those who have acquired substantial wealth at the point of death have many things to take into consideration.

Estate taxation is essentially a transfer tax imposed at death by the government upon an individual who wishes to pass his or her belongings or assets to someone who is living. Generally, the higher the value of the estate at death, the greater the tax burden imposed. Proper estate and financial planning techniques can be utilized to legally minimize such transfer taxes. (Dohrn Insurance Training offers a 15-credit hour fully certified continuing education course entitled "Estate Planning Basics" revised 1997, which throughly examines the issues associated with property transfer at death and the options available (wills, trusts, contracts and the use of insurance).

Whether it is the clients objective to minimize income or estate taxes, or both, perhaps the best way is to consult professionals who are experts in these areas. The main impediment is the potential cost of seeking expert advice. However, **by not consulting experts, individuals will run the risk of improper or poor planning that will cost far more in the long run than the current price structure of tax professionals.**

2) Keeping Pace With Inflationary Pressures

When a person invests money, what should he or she really be trying to accomplish? Objectives may vary, but unless funds maintain, retain or exceed their current purchasing power over time, the investment is a relatively poor one. Investing money in a place where risk is minimized and return is maximized is a tricky business even for experts.

The general rule is:

THE SAFER THE INVESTMENT,
THE LOWER THE RETURN.

Yet, if the return is not high enough over time, the value of the money becomes more meaningless with respect to purchasing power at a later date. If the investment vehicle is

income taxable, it is even more difficult to retain purchasing power over time. **What is a relatively safe investment which will give a fair return (without current taxation interfering with that return while accumulation occurs) and may be a reasonable alternative to low returns or high risk? In the insurance industry, such an investment vehicle would be the annuity or perhaps an interest sensitive life insurance product**. *(Dohrn Insurance Training offers a 15 credit hour fully certified continuing education course entitled "Interest Sensitive Insurance Products" revised 1997, which compares and contrast popular forms of interest sensitive insurance contracts as well as annuity products both fixed and variable*).

3) Accumulating Funds for Retirement

Americans accumulate funds for retirement in three ways:

- it is done for them through a company pension plan
- through federally regulated retirement programs such as Social Security; or
- the individual takes some steps on his or her own to save for the future.

Future income needs versus the reduction of purchasing power over time due to inflation must be conscientiously examined. The main culprits preventing future accumulation are the first two priorities discussed: income taxes and inflationary pressures. Examine the first step, minimizing income taxes, with respect to saving for retirement purposes.

Is the accumulating growth fund being taxed on an annual basis or is taxation being deferred into some distant point of time? Obviously current taxation serves to reduce the capital pool upon which periodic interest is paid. Over the course of many years, this reduction severely limits the growth potential of the capital pool (i.e., compare the long term growth of a savings account [taxable] with that of an annuity [tax deferred] in which all other amounts are equal).

It is difficult enough to save on a conservative basis for the future yet retain the purchasing power the saved dollars represent. The payment of income taxes on an annual basis makes such a task nearly impossible. One way avoid risk as a long term savings strategy, yet keep pace with inflation, is to utilize a tax deferred growth account. **Establishing an IRA should be the first concern of anyone eligible to participate.**

4) Insurance and Risk Transfer

This is, or at least should be, a main concern to most Americans. The financial protection of possessions through property and casualty insurance is a readily understood concept. The need for more intangible risk transfer vehicles, such as life insurance and disability income insurance, are perhaps not as widely understood and accepted. It may seem ludicrous, but many Americans accept the concept of purchasing homeowners insurance ahead of the insuring against becoming permanently and totally disabled or dying prematurely. Yet which has the larger loss potential: the total loss of a home valued at $150,000 or the next twenty to thirty years of lost income?

The reality of risk transfer is that it costs money. Therefore a basic prioritization of risk must be developed by clients and conveyed to the planner so that the planner can recommend appropriate protection elements while keeping within the client's budget. It is perhaps an understatement to say most middle class Americans would have difficulty in paying the premiums for adequate and proper risk transfer in all areas of life, health, property and casualty. A logical and cost-effective plan must be recommended and implemented; a plan which utilizes most effectively the value of every premium dollar spent.

The basic purpose of any insurance is to transfer economic risk from individuals to an insurance company in exchange for premium payments. The naked alternative is to bear the risk as an individual if and when loss should occur. This notion is totally unacceptable with regard to many such risks which could occur (i.e., total and permanent disability resulting in lost income for life, total destruction of a valuable home with or without a mortgage, premature death and the resultant permanent lost wages).

5) Fringe Benefits From Employment

It is very valuable for any working American to fully understand the benefits available through employment which are over and above wages. Many studies have been done to demonstrate that, although wages are an important element of a worker's compensation, fringe benefits can provide an additional 25 - 40% of compensation above the gross salary itself! Fringe benefits can range from nothing to excellent. Employer provided health insurance coverage, life insurance coverage, disability income coverage, and qualified and nonqualified retirement plans with matching funds from employers can easily be taken for granted for those who enjoy them but do not pay for them.

The insurance prospect who will automatically waive the notion of examining current coverage with the standard objection "I don't need any life insurance because I have it through work" may be accurate. Then again, it may not. If the employee mistakenly believes he has a much greater amount of coverage than actually exists, then that individual is assuming a far greater risk for his or her family than is acceptable.

It is critical for employees to take the time to fully understand the exact nature of any fringe benefits offered or available from employers. Any weaknesses must be identified, addressed and paid for by the individual.

SECTION IV: Insurance Lines and Their Role in The Financial Planning Process

Much of the study in this course deals with the various insurance contracts that compose such an important role in the financial planning process. The lines of insurance include property and casualty, health insurance and life insurance including annuities. After addressing these areas of risk transfer, some selected business insurance topics will be addressed including the life insurance buy/sell and pension plan formation.

Areas of Risk Transfer

1) Property and Casualty concerns encountered specifically by the small business owner and the individual require are addressed. **Property insurance allows those who have a financial interest in real or personal property, to own protection against loss or destruction.**

Obviously the need to the individual for homeowners and auto insurance are critical. Very often the planner will be assisting a small business owner. This owner of a business has many property and casualty concerns related to the business which, if not properly identified, can lead to personal financial ruin.

Government statistics record that America has more than 11 million corporations employing five people or less. In addition there are well more than ten million more small businesses which are sole proprietorships or partnerships. These business owners could be wiped out financially in one day unless their basic risk transfer needs are properly addressed.

If a business owner has purchased a physical plant in which to do business, the destruction of such a building by unexpected loss beyond the control of the owner, would have a devastating impact on the business itself. Basic fire coverage would be mandatory. In addition to real property (land and anything affixed to that land) damage, other physical assets which are housed within a plant also have value and would be quite costly to replace. Such items as machinery (if the business is manufacturing) or office equipment would be expensive to replace unless risk was transferred to an insurance company.

What if a visitor to the business was to trip and fall and become seriously injured? The business and its owners could be liable for any damages. These damages could be paid from coverage granted through an insurance policy. Protection from vandalism and theft would also be of primary concern to the

typical business owner. A policy which clearly states covered perils, as well as the circumstances under which losses will be reimbursed, is necessary.

Beside property theft and general liability concerns, many professionals who own businesses (i.e., doctors, attorneys, CPA'S and insurance professionals) have a basic need for Professional Liability Insurance (i.e., errors and omission). If one of these professionals makes an error for which they can be held liable, there is a chance that even the most successful professional could be economically ruined.

Errors and omission insurance can be quite costly, depending upon the profession in which you are engaged. For instance, it is common for some physicians, most notably obstetricians and brain surgeons to pay from $200,000 to $400,000 per year in insurance premiums. As more and more law suits are filed and damages are paid, the cost for errors and omission insurance rises each year. The premium cost for such a policy is simply the cost of doing business. Whether or not such costs rise to such an extent it becomes a barrier to entering some profession remains to be seen.

Now consider all these potential liabilities with respect to the small business owner as an individual. Without the proper business coverage, liability could extend and attach to the personal assets of professionals and business owners. This potential for personal liability is perhaps just as important as the coverage needs for the business itself.

The business owner market has sometimes been referred to as the "professional" or "white collar" market in the insurance business. The typical business client can be an important ongoing source of business for the insurance professional. It is crucial for the insurance professional to properly understand and deal with the needs of the small business owner as both a business person and as an individual.

The individual who is not a business owner also has many property and casualty insurance needs. Whether an individual rents or owns property in which to dwell, basic fire, theft and general liability insurance is considered a necessity. The basic homeowner policy would insure against loss resulting from fire and many other perils which would be stated in the contract itself. To not transfer this risk of destruction to one's home is an unacceptable concept from the point of view cost versus risk.

The premium cost to replace a substantial asset, like a $150,000 home, can be as minimal as $1.00 a day. The immediate loss of an uninsured $150,000 asset would financially wipe out most individuals. Of course when a mortgagee is involved, the owner of the house is forced to buy fire coverage as a condition of the mortgage. If there was no lender and a house was owned free and clear, would the owner still purchase fire insurance without a third party making it mandatory? Very few people would forego coverage in this circumstance. To do so would be foolhardy and an unacceptable risk in relation to the premium dollars saved.

People who rent are also at a substantial risk and must consider an insurance policy covering tenants. Fire to a rented area could destroy many personal assets which may not be covered under a landlord's fire policy. The general liability potential of visitors to the rented space who become injured places a distinct potential for financial loss on the renter in much the same manner as it does to the homeowner. The cost to transfer this risk is once again minimal in relation to the potential for financial loss.

Casualty insurance, in the form of a personal automobile policy, is mandatory under law in all states. **The typical automobile insurance policy offers protection both in the casualty and property areas.** The casualty portion is referred to as the liability section of a policy and it pays on behalf of the insured when the

insured is held liable for negligent acts involving covered automobiles in which harm comes to some other person or property. The property portion is referred to as the physical damage section and this protects the insured from economic loss when an insured's motor vehicle is accidentally damaged, destroyed or stolen.

Many types of financial ruin could happen to any individual at any time. For example, faulty breaks in a family auto could result in injuring dozens of pedestrians on a busy downtown sidewalk at lunch time. This scenario points to the absolute necessity for property and casualty coverage when someone owns and operates an automobile. Without this type of coverage, anyone whose operation of a car resulted in serious injury to others would likewise result in the financial ruin to that uninsured motorist.

Another typical section in automobile liability policy is a medical payment expense insurance portion. This type of insurance pays money to an insured for all reasonable expenses incurred within one year from the date of an accident for necessary surgical, dental, medical services, X-rays etc.

The cost of a premium must be weighed against the potential for loss. To pay excessive premiums is to rob the insured of valuable dollars that could be more effectively utilized elsewhere in the financial plan. For example, many people own cars whose book

value is minimal yet these people pay for comprehensive coverage. Several hundred dollars a year in premiums are wasted to protect an asset with little value. The effective planner will analyze existing coverages for such waste and recommend its removal from the overall plan.

In briefly summarizing property and casualty risks, to both small business owners and individuals, it becomes clear that some basic needs must be served, on a priority basis, to the needs of some other areas. Anyone who has assets to protect must obviously consider various basic forms of property and casualty insurance to avoid the financial ruin that could result from circumstances beyond the ordinary control of an individual or business owner.

2) Health Insurance: and The (small) Business Owner

The vast majority of health insurance in America is group health coverage rather than individual coverage. This section will discuss, in a general format, the basic types of health insurance available to the small business owner, employees, and individuals.

Consider the health insurance needs of the small business owner and his firm. In the event a small business owner wishes to take out a group health plan for himself and employees, several group health benefit varieties are available from which to choose. **Traditional group coverage available through common carriers has been major medical and comprehensive coverage.**

Major medical is designed to provide insurance for large coverage amounts. Normally the insured pays some limited amount of first dollars incurred from loss (known as deductibles) and then some co-payment amount or shared expenses (coinsurance percentage) are payable up to a stated stop loss limit. The **stop loss limit** represents the maximum out-of-pocket dollars that can be expended by the insured. After the stop loss dollar amount is met by the insured, the insurance company provides 100% coverage until some contractually specified amount, up to $1,000,000 or more, has been paid.

Comprehensive medical insurance does everything major medical does and also picks up many of the first dollars and co-payment amounts which would not be covered under major medical. This form uses many basic coverages like

daily hospital riders and miscellaneous expense policies to help pay for deductible and copay expenses. However, such additional coverage makes comprehensive medical insurance, since it offers the broadest coverage, very expensive.

Both major medical and comprehensive have served the health insurance needs of most Americans for several decades. However, recent increasing costs for health care have resulted in higher and higher premiums providing fewer and fewer benefits. This has led to alternative sources for health coverage like service organizations (Blues Plans), the health maintenance organization (HMO) and the Preferred Provider Option (PPO).

HMO or Health Maintenance Organizations - provide prepaid, prenegotiated comprehensive health care. HMO's stress preventive health care as a strategy to keep people healthier and to lower health care costs. The HMO typically provides more care in an outpatient environment rather than the more expensive inpatient method, thus reducing the net cost of the HMO system. The growth of HMO's has been explosive since 1973 when the federal government began requiring employers with 25 or more employees, who offer health care

benefits, to offer enrollment in an HMO if membership in a federally qualified HMO served the nearby area. HMO's service is usually contracted for on a "local geographic area" basis and the nature of their structure has prevented them from being successful regionally or nationally in scope.

In an HMO the Doctor is paid on a system of "Capitation" rather than upon the familiar fee for service basis. From the "subscriber's" (the person receiving benefits under and HMO agreement is called a subscriber or an enrollee, BUT NEVER AN INSURED) perspective a regular fee is paid in exchange for virtual 100% medical care required throughout the year. The four basic models of HMO's include:

● **The Staff Model** - a group of doctors with various specialties, who are salaried employees of the HMO, provide physician services to the HMO.

●**The Group Model** - a group of doctors with various specialties is an independent group and contract with the HMO to provide service on a "per head" cost basis. They are not employees of the HMO and serve other (non-HMO) patients as well.

●**Individual Practice Associations (IPA)** - Doctor's in the model agree to treat HMO patients at their own office and to provide medical services to the HMO. The Doctor bills the HMO (not the patient) for services rendered on a fee for service basis within an agreed upon range. The doctor has the risk of earning reduced fees if the revenue of the HMO is not sufficient to provide full payment.

● **Network Model -** very similar to the Group Model except that the HMO signs many contracts with several physician groups who offer multi-specialty doctors. The Groups receive a monthly "per enrollee fee" and then the group decides the amount to pay each doctor.

In the HMO concept, the "primary care physician" is given the responsibility for deciding what care is given and when a specialist referral must be provided.

Preferred Provider Organization (PPO) - this is a network in which **an employer or insurance company contracts** with a medical group of health care providers **(hospitals and doctors).** The **insured will receive a discount** in the form of lower deductibles or copays **when utilizing the PPO providers** rather than going out of the network for care

(which is a choice the insured can make, but one for which the discounts of the PPO will not apply. **This system allows the covered party to seek treatment outside of the network (greater choice) than would be the typical case in an HMO.**

Service Organizations (I. e., Blues Plans) are **nonprofit associations like Blue Cross (hospital coverage) and Blue Shield (physician coverage).** They provide group medical expense plans on a **"prepaid" basis**. These groups offer the same or similar benefits provided by commercial carriers. The favorable tax treatment they have been afforded (although some states have eliminated these tax breaks) enables them to compete in the health insurance marketplace often at lower cost than commercial carriers. **They are not insurance companies** but they are regulated by the state department of insurance. The unique feature of BC/BS plans is that it uses a **service approach** instead of a reimbursement. Rarely does the "**Blues," or "Subscriber**" (cannot refer to a covered person as an insured), receive direct payment of any kind.

Service organizations are hospital expense prepayment plans that provide hospital and physician benefits. A well-known example is Blue Cross/Blue Shield (blues plans). Under a service organization plan, the subscriber (insured) only has to

pay for services that are not covered under the plan. A hospital providing services is paid directly by the organization. **Rarely does the subscriber receive any type of reimbursement under this type of plan.** Blue Cross and Blue Shield have signed contracts with hospitals and doctors for rendering service to subscribers in accordance with rates or fees that are agreed upon in advance.

Another need centers around long term disability. If the small business is owned by two or more partners or co-shareholders in a closely held corporation, the permanent disability to either key person would have a devastating effect on the long term success of the business. **A disability buy/sell agreement should be considered**.

While many people are familiar with the life insurance buy/sell concept, comparatively few business owners are aware of, or have engaged in, setting up a disability buy/sell agreement. In the event one of two or more owners becomes permanently or totally disabled, a disability buy/sell will provide a lump sum of cash to the disabled partner in exchange for transfer of ownership to the remaining healthy partners. In this manner, the disabled individual gets what he or she needs (money) and the remaining owners get what they want (the disabled person's ownership in the business.)

Business overhead expense or BOE insurance is another consideration, especially for the small individual business owner. BOE is designed to help business owners meet regular periodic and relatively stable business expenses for which the insured is responsible during times of his or her total disability. Identifiable expenses such as rent, utilities, employee salary, etc., can be paid even when an owner cannot produce revenues for the company because of a total disability.

A central concern in any small business contemplating ny of the above health insurance products is, of course, money. The trade off between coverage and premium dollars is becoming more and more of an issue in the marketplace today. As medical expense insurance cost dramatically rises, business owners are forced to either lower profit margins to keep levels of coverage constant or to reduce benefit levels to the employees of the business. It is not an easy decision for the small business owner to make.

When it comes to the disability concept, as previously discussed, many small business owners view coverage as an additional expense further cutting into narrowing profit margins. Again, from the planning point of view, the relative cost versus the possible loss must be seriously contemplated.

The Individual

There are many types of insurance an individual must consider during the course of a lifetime. When an individual is not covered under a small group or through a larger employer, the burden of providing health care falls on that individual. Individual hospital expense plans are readily available in the marketplace but huge cost and benefit difference exists. A consumer must take time and be very aware of the differences in coverage.

The individual health purchaser should be prepared to pay more money for fewer benefits than their covered employees' counterpart. Furthermore, there is not a broad arrangement of benefits available and dependent children have a cost factor that must be paid for each child up to perhaps 3, 4 or even 5 children before any additional children are covered automatically. Under most group health plans the cost for dependent coverage per child is the same whether there are one child or ten children.

Many consumers opt for an indemnity based basic medical insurance products. This product typically indemnifies a limited amount of money for hospital, medical and surgical expenses for limited or specific periods of time.

Basic plan benefits pay a flat daily rate or a small percentage of cost incurred, without consideration of the actual cost involved. In other words, a typical hospital expense rider may provide $100 per day for every day spent in the hospital while the actual cost of the hospital room is $500 or $600 s per day. These limited or basic plans should be examined carefully because the cost may seem less expensive at face value compared with major medical cost to an individual, but the coverage will not be substantial enough in the event of a long term or serious illness.

In the event of serious illness, major medical would cover or high maximums while the basic plan would pathetically run out in fairly short order. The answer may be a major medical plan with a high deductible (i.e., $1,000, 2,000 even $5000 deductible in order to keep the premium low). While a person may be able to recover from paying $2,000, 5,000 or $10,000 out-of-pocket, they may never be able to recover from a $200,000 or $300,000 hospital bill.

As Americans reach retirement by age 65, the Medicare system under Social Security is designed to provide health care. At this time virtually everyone must consider some sort of "Medicare supplement." While Medicare, through its Part A and Part B coverage, can provide low cost health care to senior citizens, the unwary may be caught short and have to pay tens of thousands of dollars out-of-pocket for expenses not covered by the program.

Medicare provides for hospital coverage up to a one year stay in a hospital for but a sizable inpatient deductible must be paid by the insured. Medicare Part B provides payment for physicians services with a $75 dollar deductible paid by the insured followed by an 80%/20% coinsurance up to a maximum stop loss limit.

However, **under Part B, every senior citizen should be aware that Medicare only pays for costs which are deemed to be "reasonable and necessary" by the Medicare system**. In the event a person covered under Medicare has a doctor who charges more than Medicare deems reasonable, the senior citizen will be responsible for any amounts over and above the "reasonable and necessary" level.

Medicare supplements are policies offered by private insurance companies which are designed to pay some or all of the charges not covered under the Medicare program. Supplements generally fall under the same guidelines that are used by Medicare, and they will not pay for services deemed unnecessary. In every state, a Medicare supplement policy must meet specific minimum standards as established by law. Medicare supplement coverage can seem costly to a senior citizen on a fixed income and the ability of the senior citizen to be able to afford this coverage is a prime consideration when counseling this age group.

Another area concern in the news lately has been long term nursing care. The federal government does not provide for people who will be in firmed for periods of time extending to many years. Under the current system, a person must go through virtually all of their net worth before the federal and state governments will step in and provide the monetary support through "Medicaid." Under Medicaid coverage, those who are poor and indigent and cannot meet Medicare deductibles or pay the cost of extended nursing home care, will have their bills paid by the federal government after net worth has evaporated.

People who are eyeing retirement with the possibility that they may someday be in a nursing home, may consider one of the various nursing home products that has been made available in recent years. A nursing home policy will generally provide a fixed daily amount of money for a specified period of time (currently up to five or ten years) in return for an annual premium payment in advance, in the event long term care may someday become necessary. Those who can afford such premiums, or have a serious desire not to become a burden on others, may find this type of coverage highly desirable.

Here are some specifics as to what long term care contracts offer:

There are three basic recognized levels of care:

●SKILLED **- daily nursing and rehabilitation provided by skilled medical personnel** (a registered nurse acts upon the orders of a licensed physician. (THE MOST **EXPENSIVE** LEVEL OF CARE).

●**INTERMEDIATE** - the same **care as offered in SKILLED, except that the care is intermittent or occasional and is not provided on a daily basis.**

●**CUSTODIAL - help provided in performing "activities of daily living" (ADL);** eating, help in getting in or out of bed, bathing, dressing, toileting, etc. The **care givers are not medically skilled** although care is based on a physician's certification that care is needed. (LEAST EXPENSIVE OF THE THREE).

The typical coverage and **pertinent contract** protection offered in a LTC contract includes:

●**BENEFIT AMOUNT** - A fixed number of dollars will be paid daily as specified in the agreement for the length of a stipulated indemnity period (i.e., one yr., two yrs. etc.). Daily benefits can

range from $30 for home health care and up to $150 or more for skilled nursing care. Home health care benefits are being increasingly offered by insurers and the benefit is usually 60% of the ADL benefit amount.

●**INFLATION PROTECTION** - the benefit amount can be optionally increased by the insured (usually at a minimum rate of 5% compounded annually) without requiring proof of insurability.

●**ELIMINATION PERIOD** - the time deductible idea, whereby the longer the insured will pay out-of-pocket once a claim begins (but before the policy takes over and provides benefits), the less the premium cost.

Individual Disability Income

When it comes to financial planning, one area that is normally overlooked completely, or for which premiums are not allocated, is the area of long term individual disability. The table below shows the percentage chances of the average individual, at various ages, of becoming disabled compared with dying at that same age. Study the chart carefully and you will see that the odds of long term disability are many times greater than the potential for death, over the same periods of time.

AGE	CHANCE OF DEATH	CHANCE OF 90+ DAY DISABILITY
20	< 2.5%	10.0%
25	< 3.0%	12.5%
30	< 5.0%	16.0%
35	< 7.0%	20.0%
40	< 10.0%	25.0%
45	< 15.0%	25.0%

In discussing **individual Disability Insurance**, several definitions must be addressed. Disability income policies are primarily designed to cover long term disability as a result of injury or sickness. Consider the definition of disability. **Disability can be total in nature or "partial" or "residual."** Disability is the inability of an insured to work and earn income due to some injury and sickness. In the event of total disability, it would be the inability of an insured to do any of the duties or work elements in which he or she was engaged.

Disability policies protecting against total disability can define disability with respect to either "your own occupation"

or "suitability due to training or education" standards. There is a major distinction between the two definitions.

If a person becomes totally disabled and is unable to work **in their own occupation,** it specifically means the duties in which they are currently engaged. By contrast, the training and education definition can be far less generous in this regard. To be unable to work and earn income due to injury or sickness in a job for which you are suited **by training and education is a far broader description than your own occupation.**

A good example is a brain surgeon who totally and permanently injures one or both of his operating hands. An own occupation provision in his disability policy will result in full benefits being paid even if that doctor can earn as much money as before in the areas of consulting and teaching. With a training and education definition of disability that same doctor would receive no benefits and may have to take a drastic reduction in income because the doctor would be suited and trained to duties other than the actual act of surgery. Any professional or small business owner must be made aware of this type of definitional distinction in a disability income policy.

Because of higher benefit payouts than originally anticipated, moat companies have shied away from offering own occupation coverage in DI contracts

If disability is less than total, it is considered to be partial or residual in nature. A **partial disability** is the inability of an insured to perform one or more important duties of his profession or occupation, having returned to work in some limited capacity. The benefit which is payable and the coverage time is reduced or limited compared with coverage provided under the definition of total disability. Partial disability is normally defined in occupational terms with respect to time and duties. In other words, what can the insured do now compared to duties he could undertake prior to any disability? Payment is made on this basis of limited ability to perform.

On the other hand**, residual disability** is different from partial because the main function is to protect income, rather than occupational performance. Residual disability has been the trend for the last several years in the insurance industry. Benefits are paid to an insured after he or she returns to work s follows: since the insured is unable to perform one or more important duties in the job and therefore receives less than a full percentage of income, any missing percentage of income, within limits, is reimbursed. The residual clause looks at the

bottom line and makes up loss income while the partial clause, instead, evaluates the insured's ability to currently perform tasks opposed to past performance levels.

Premium cost and benefit payment relationships are clear in the disability policy. **The three main relationships** to consider when purchasing a disability insurance income policy include the **elimination period, the indemnity period and the benefits amounts**.

Benefits under a disability income policy are normally paid monthly but, prior to any payment, an elimination period must first be applied. **Elimination period** is the deductible of time which can keep the cost of coverage lower. The longer the waiting period selected, the lower the premium. The elimination period is the amount of time an insured is willing to wait from the point of loss until the first benefit check arrives.

Indemnity period is the total time a contract will cover any single accident or illness. The longer the indemnity period selected (i.e., 1, 2, 5 years, age 65 or life to 100) the higher the cost of coverage.

Benefit amounts also have an impact on cost. The higher the benefits amount and the greater the benefit levels, the more expensive the coverage.

Two important considerations in underwriting disability income insurance are the **occupation and income level** of the perspective insured. While professionals such as doctors, lawyers, CPA's, small business owners, etc., can enjoy relatively low premiums in exchange for comprehensive long term coverage, their blue collar counterparts must pay comparatively hefty premiums for limited coverage.

When dealing in the white collar and professional market, it is imperative that the planners strongly encourage the client to consider an adequate disability coverage policy. When dealing with a blue collar market, premium dollars may not be as available. One possibility to consider would be coverage enabling a blue collar worker and family to meet mortgage payments.

When **evaluating riders** to the basic disability coverage, several important concepts must be weighed. The first is **waiver of premium.** In the event that someone becomes otally and permanently disabled, the last thing they will want to do is continuing paying premiums out of their benefit checks. This is a simple consideration and policies stop requiring

payments once benefits begin to be paid. Fewer obvious choices include social insurance supplements, cost of living riders, guaranteed insurability, and residual versus partial disability clauses.

The **social insurance supplement** is important because it provides a benefit to an insured while he or she is making a claim under the Social Security system. If Social Security accepts the claim, then a social insurance supplement does not pay. However, if the claimant is denied or delayed payment under the Social Security system, then the social insurance supplement rider pays the amount of the denied claim to the insured for a specified maximum period of time.

This is an important rider because Social Security does not begin benefit payment until the end of the fifth month of disability at the earliest and most claims are initially rejected. A lengthy appeal process can deny paying benefits for up to two years, or completely. The cost for this additional coverage is small compared with the benefit cost for the same amount of disability coverage unrelated to social insurance. The social insurance supplement is a way to lower overall premium costs but provide for gaps in coverage which might otherwise occur.

The cost of living clause (COLA) is essential to a policy because when someone is permanently disabled living on a fixed income will result in a constant reduction in purchasing power. The cost of living clause, within contractual parameters, will guarantee increased payments to a claimant for as long as they are disabled and the increases would be based or tied to the federal Consumer Price Index.

Guaranteed insurability should not be ignored. Any successful person will continue making larger and larger sums of money as their career unfolds. Accordingly, increasing amounts of coverage must be purchased to match rising earned income. Guaranteed insurability riders allow the successful professional to **purchase additional amounts** of coverage at future points in time, **without regard to insurability considerations.**

Do not confuse the benefit of having a cost of living clause with what the guaranteed insurability clause is meant to do! The cost of living clause **only affects benefits once a person actually becomes disabled.** It is the insured's responsibility to periodically increase coverage through the guaranteed insurability provision.

Finally, the insured should analyze the contract or offer coverage carefully **to see whether partial or residual**

disability is part of the policy. Remember, partial disability defines loss in terms of occupational duties while residual disability looks at the bottom line dollar amount and makes up any differences as stated in the contract.

Life Insurance: A basic Product Review

Whole Life ("Permanent" Insurance)

Whole Life, also known as "permanent" or straight life, provides death benefit coverage for an individual's entire lifetime (normally to age 100). At age 100, the accumulating cash value of a policy will equal the death benefit. Prior to age 100, death must occur in order for the policy proceeds or face amount to be paid.

Common characteristics of all whole life policies include:

- a level and guaranteed premium
- a level and guaranteed death benefit
- a constantly growing cash value that which will equal (endow) the death benefit at age 100.

The appeal in purchasing whole life rests upon the exchange of a level guaranteed premium for a level death benefit. In the event of premature death, the face amount only is paid (cash values are not paid in addition to face amounts). However, the accumulated cash value may be accessed through either a policy loan or by surrendering all death benefit at any time prior to death.

The weaknesses of traditional straight life centers around the internal rates of return on amounts paid into the plan. Since a long term cost factor and death benefit are being guaranteed, the insurance company only offers a conservative and guaranteed rate of return on the money placed into the policy. Until the late 1970's and early 80's nobody paid much attention, but hyper-inflation and quickly increasing interest rates exposed this weakness in a dramatic fashion.

Another form of whole life **is the limited pay policy**. The limited pay policy has the same three characteristics as straight life (level premium, level death benefit and constantly growing cash value endowing at age 100). The structure of the plan's payment is different. By paying for coverage in a condensed time frame which is shorter than one's entire life, the regular installments are higher than for a comparable straight life policy but fewer installments are made over time.

The actual number of payments is limited. Most people are familiar with the most common limited pay plans of 20 Pay Life and Life Paid Up at 65.

The most extreme form of limited paid life is Single Premium Whole Life. Single premium whole life requires one payment in exchange for lifetime coverage with a constantly growing cash value which accumulates and endows to the death benefit at age 100.

A single premium plan would is considered a "Modified Endowment Contract" (MEC) under current tax law. The modified endowment contract places further restrictions on what is considered life insurance and what is considered an annuity.

Whether or not a current contract is considered life insurance or a MEC 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 payment exceeds this 7 pay test (i.e., six pay life, five pay . . . single premium) the contract no longer qualifies as life insurance. Instead, the contract becomes a modified endowment. Contracts that meet this definition are generally those entered into after June 20, 1988 which pass the

existing definitional tests relating to guideline single premium and guideline level premiums under the "corridor test." Life insurance contracts that fail the 7 pay test for premiums are MEC's. Additionally, contracts that are entered into before June 21, 1988 can be subject to these rules if they undergo a material change. Contracts received in exchange for a contract which meets the modified endowment definition are also included.

A modified endowment treats accumulating cash values as it does under any life insurance contract, but any amounts that are received from dividends, withdrawals or surrenders are treated like amounts received under annuity contracts (income taxable to the extent they exceed premium payment amounts). The first money out is income and taxable. In other words, a single premium whole life policy is still life insurance with respect to permitting tax deferred accumulation for cash values. Any attempt to withdraw money creates a taxable event (plus a 10% penalty if the insured is under age 59 1/2) if the money taken is in excess of premiums paid. Under the modified endowment concept if you leave the cash alone, your contract is treated like life insurance. If you take money out, it is treated like an annuity

Interest Sensitive whole life products began being offered in the late 1970's and early 1980's. Plans including interest sensitive whole life, universal life and variable life have captured the attention of millions of consumers in America. The basic concept of all interest sensitive products, except interest sensitive whole life, is to minimize insurance costs on some type of current mortality cost basis with a guaranteed cap, while placing any premiums above cost into a life insurance policy account or cash value. The policy account is then allowed to accumulate on a tax deferred basis with the application of an interest rate which fluctuates with the economy.

Interest sensitive products can range from the relatively s afe (whole life and universal life) to the somewhat risky (variable life, variable universal life). Many cost and load differences between insurance companies with respect to interest sensitive products places consumers at the mercy at whomever is advising them on the topic.

An interest sensitive whole life contract is designed to provide the average consumer with a place to accumulate money over and above insurance cost on some tax deferred and a current interest rate sensitive basis. However, attempts to utilize the cash values are still met with the requirement of repaying substantial interest rates that are tacked onto the loan.

In the case of universal life, the ability to recover the cost basis of the policy from the policy account without income taxation, has made it a huge success in the insurance industry.

Term Insurance

Term insurance is temporary life insurance, or death benefit coverage for a specified or limited term of time. Term life insurance does not accumulate any cash value. **It is simply the exchange of insurance protection for premium dollars.** Like whole life, term insurance can be packaged in many formats such as annually renewable, 5 year, 10 year or 20 year level term. Term can also be purchased with a decreasing face amount.

The idea behind term insurance is to pay only for the death benefit as cost is actually incurred, instead of prepaying and accumulating a cash side fund. Statistically, the older an individual becomes, the greater the life insurance risk he becomes. Term insurance allows the consumer to purchase with a "pay as you go" philosophy.

The reason for the success of the "buy term and invest the difference" concept has been so widely accepted is mostly a function of the present, versus the future, value of a dollar. A

young term purchaser pays as cheaply as possible today and invests the premium savings. As he ages, he pays premiums with weaker dollars, all the while building his own more formidable cash account. The cost savings and their subsequent investment, in theory, will eliminate the need for insurance in the older stages of life.

In examining the basic difference between an annual term, a 5 year, 10 year and a 20-year level term insurance product, the main factor to consider is cost. Although all term contracts must guarantee a cost basis on some level, current rates charged under any contract are far less than the maximums which could be assessed in the event mortality rates increase dramatically over the coming years.

The least costly way, from a present and future value point of view, to purchase term insurance is on an annual renewable or a 5 year level cost basis. When a consumer goes to 10 and especially a 20-year level term coverage plan, they are being charged more in the early years for a price break later. This later price break becomes meaningless, since the purchasing power of the dollar is lessening over time. Inflationary pressure makes the purchase of a 20-year level term product a poor choice.

Most people buy term insurance because they simply want the lowest cost protection available, perhaps with the idea of investing any cost savings (achieved by not purchasing permanent insurance or other, more expensive term products) into some other investment vehicle. Look at the chart below and compare a 5-year term cost product to a typical 20 year product, taking into consideration present and future value of money.

$100,000 FACE AMOUNT, MALE AGE 35, NONSMOKER

POL YR.	5 YR. POL. ANN. COST	20 YR. POL ANN COST	PREM. SAV W/INTEREST
1	$ 115.00	$ 259.00	+ $ 155.50
6	$ 190.00	$ 259.00	+ $ 912.37
11	$ 250.00	$ 259.00	+ $ 1,777.74
16	$ 355.00	$ 259.00	+ $ 2,669.11
END OF YEAR # 20			**+ $ 3,313.54****

***** Represents the dollar value, in 20 years, of what this client could have kept by purchasing the 5 year level term instead of the 20 year level term and investing the savings each year at an 8% annual rate of return.***

Term Riders

There are three main riders that should be considered by anybody making a term purchase. These include the waiver of premium, convertible and renewable riders. Waiver of premium is a rider under which an insurance company will waive premium payments owed by an insured in the event an insured becomes totally and permanently disabled

There is normally a six-month waiting period which presumes the disability, with medical corroboration. Once this six-month period elapses, the company refunds premiums paid for the first six months and will continue to pay premiums into the future for as long as disability remains.

Waiver of premium is especially important to add to a term contract because, in the event the insured becomes totally and permanently disabled, the insurance company will at some future point (normally age 60 to 70) convert the term plan into a permanent plan of insurance and make the payments for the insured at the permanent premium cost. The benefit is that the insured is covered for the rest of his or her life and may draw on and borrow against the cash values which will accumulate once a conversion has occurred. The reason the insurance company automatically converts coverage at an advanced age is a matter of economics: permanent insurance becomes less expensive than term at some identifiable age.

Convertibility and renewability are also extremely important when making a term purchase. The convertible rider will allow an insured the right to convert or change a term policy to any permanent policy offered by a company within a specified period of time, without requiring the insured to demonstrate insurability. An older man insured under a term contract, who has a severe heart problem, may live for many years and may wish to convert from term to whole life when it becomes the most cost effective to do so. The **convertibility rider** will insure that an individual in this circumstance will have the ability to exercise such an option.

Renewability offers the insured the right to renew a policy for some period of time without being required to prove insurability. Normally a renewability feature is restricted by age (perhaps up to age 100, age 70 or 65, or by the specified number of times renewed) Renewability is important because if someone's health circumstances change and the term coverage is ending, the right to renew to some further point in time, at guaranteed insurable rates, becomes crucial.

Term policies which are neither renewable nor convertible are also available in the insurance marketplace. Such policies when purchased signify that the client is only

interested in cheap insurance for a very limited period of time (normally 5 years). An individual purchasing a nonrenewable and nonconvertible short term insurance plan must do so with the understanding that if health circumstances deteriorate, coverage can end before that individual may have liked, without the option to continue the insurance contract.

Annuity

An annuity is an insurance contract (LIFE class). The annuitant or recipient invests money with an insurance company and the company agrees to provide a lifetime income to the annuitant.

Annuities can be "fixed," "variable" or "combinations." The annuitant **can invest or pay with a single premium, in a disciplined or regular fashion or flexibly** (vary the amount and time of investment to suit personal convenience).

The time during which premium payments are made is called the **"accumulation stage."**

Benefits can be received by the annuitant on either an "**immediate"** (single premium only) or **"Deferred"** (some future point in time) basis. **Annuities that may be purchased**

include single premium immediate, single premium deferred and periodic payment (flexible) deferred.

One option for receiving benefit payments is called **"Annuitization"** (a fixed, lifetime basis). The **other option** available is to simply take all the money in **a single lump sum withdrawal**. However, once annuitization is elected, no change to lump sum withdrawal can normally be made.

Annuity Benefit Types

Life Only (Straight Life) - The annuitant receives payments fixed for life. When the annuitant dies, the contract ends (even if only one payment has been made).

Life Annuity with Period Certain - Payments are both guaranteed for life and for a minimum period of time (5, 10, 20 years, etc.), **whichever is longer**. Any balance of time remaining on the guaranteed Period Certain is paid to a named beneficiary or to the owner's estate.

Cash or Unit Refund Annuity - a lifetime of payment with the guarantee that, if the annuitant has not been paid benefits

that equal the value of his account, any unpaid balance is paid to a beneficiary (usually in one lump sum, but normally the beneficiary also has the option of annuitization).

Joint Life with Last Survivor - two or more lives are covered jointly such that, as long as one life continues, some benefits will continue to be made to the remaining life (payment is reduced to ½ or 2/3 of the joint amount).

General Concepts

Age Factor - the older the annuitant and the greater the time before benefit payout, the larger the benefit payment amount (the converse is also true).

Sex Factor - if sex-based mortality tables are used, women will receive smaller benefits than men, at the same age, because women statistically have a longer life span.

Contribution Factor - everything else being equal, the more money you put in, the larger the payment amount.

Fixed vs. Variable Annuity

Fixed Annuity (FA) - benefit payment amount is guaranteed and so is a minimum rate of interest paid on capital invested. A current interest rate may be higher but never lower than the stated minimum guaranteed interest rate.

The General account, or portfolio of medium term debt securities (bonds, mortgages), is used to guarantee payments. All investment risk is on the insurance company; if returns are lower than expected, the company suffers the loss.

Potential disadvantage of the fixed annuity: since the benefit payment is fixed (never changing for life), it cannot keep pace with rising cost of living expenses (inflation).

Variable Annuity (VA)- no guarantee as to either payment or interest rate. Payout is based on returns in the investment portfolio called the "separate account." Investment risk is on the annuitant (consumer).

VA Mortality Expense Guarantee - there is lifetime guarantee of some type of payment. The company does guarantee or take the risk of any increased mortality (people living longer than expected).

VA Operating Expense Guarantee - if operating or administrative expense exceed original projections, the company, not the annuitant, bears the additional cost.

Perceived advantage of the variable annuity: designed to fight the effects of inflation by increasing payment amounts due to probable increased investment returns.

VA Licensing Requirements - due to the increased investment risk element, variable annuities are subject to both Federal Securities and State Insurance Regulations. The insurance agent must have a state life insurance license and be at least Series Six (NASD license) qualified.

The Separate Account - since an investment portfolio is involved, technically an "investment company" exists. Investments into money markets, stocks & bonds are made, much like the diversified portfolio of a typical mutual fund. Therefore, insurance companies are required to register with the SEC as either 1 or 2, below:

1) Unit Investment Trust - (indirect investment) here the separate account does not manage securities, but merely holds

funds for the annuitant's benefit. The shares of one or more mutual funds are bought & held in a trust and **everyone owns an undivided interest in the shares purchased.**

2) Open end Investment Company - (direct investment) The separate account does manage securities portfolios and it is operated as a mutual fund. **All annuitants have an undivided interest in the securities held (these are called "accumulation units")**. There is ongoing management by a professional investment advisor and a board of managers is set up to perform the same role as a mutual fund's board of directors.

a) Investment Return mirrors that of a mutual fund, namely the separate account grows with additions of both interest and dividends from the securities owned in the portfolio of investments. Any realized capital gain from securities sales is not distributed to clients. Since there is no constructive receipt of distribution, any income taxes on earnings are deferred.

b) Investment Objectives of variable annuities are geared to capital preservation and long term growth since a common function is to provide retirement income. The investor has many choices of different separate accounts within the variable annuity (for example: bond income funds, common stock

growth accounts, money market funds, etc.) and any given percentage of principal can generally be placed in any account by the investor. The main purpose of such an ability to diversify is to not only preserve capital, but to achieve different investment objectives within **one product concept**. The term "wrap-around-annuity" is given to an annuity which allows investment in many separate or "sub" accounts.

c) Voting Rights also mirror mutual fund ownership. The voting right is based upon each accumulation unit and not the unit holders themselves. Normally, contract owners can vote on:

►Major policy items (i.e., investment objectives)
►Board of managers

d) Annuity Contract Valuation has, as the key concept, a "unit" type of measurement. The value of the investment portfolio of the separate account changes on a daily basis and it equals total market value of all portfolio securities (at the market close) minus liabilities. The two "units":

1) Accumulation Units determine the share of ownership of the separate account which is attributable to an individual owner during the accumulation phase of the deferred annuity contract. It shows what proportion of the separate account is owned by an annuitant.

2) Sales charges may not exceed 8 ½ % or 9% after charges are deducted, the net payment (amount remaining after the deduction of sales charges) is used to purchase accumulation units.

Determining the value of an annuity is accomplished by taking the value of one unit (which constantly changes on a daily basis) and multiplying it by the total number of units owned.

VALUE OF AN ANNUITY = VALUE OF ONE UNIT X TOTAL UNITS OWNED

Example:
Bert Jones owns 1000 units of ABC variable annuity and the current value is $10.00 per unit. Bert's account value is $10,000 ($10 x 1000 units). Since this is a variable annuity, value is constantly changing.

If Bert owns more units in the future but the value of an individual unit drops, his account value can still decrease (i.e., Bert owns 1500 units and each unit is worth $5.00. Bert's current value is only $7500
($5 X 1500)).

Death Benefits are usually marketed with variable annuity contracts and they cover the accumulation phase. **When the contract is insured, the owner's beneficiary receives either the current value of the account or total payments made, whichever is greater,** if the owner dies before annuitization takes place. Without an insured annuity, beneficiaries receive only the current value of the account.

Annuity Units are used at annuitization and essentially convert some fixed number of accumulation units into cash at the payout period of the variable contract. If annuitization does not occur, an annuity unit is not calculated.

Once annuitization is selected, annuity units are calculated by incorporating many variables: initial unit value, age and sex of the individual, and the selected or the assumed interest rate of the company. **The insurance company calculates the specific number of annuity units which will actually be redeemed for each payment.**

The only element fixed is the number of annuity units which will be redeemed in order to make each payment to the annuitant**. The annuitant's payment will fluctuate** because the value of the annuity units will fluctuate based on the performance of the investment portfolio of the separate account.

The Assumed Interest Rate (AIR) is selected by the annuitant or dictated by state law calculated on the separate account and it is the basis of projected future values**. It is not guaranteed**. It simply is used to adjust the value of an annuity unit as it changes relative to the investment return of the portfolio value of the separate account.

In this manner, the annuitant is always receiving the fixed number of annuity units multiplied by (the constantly fluctuating) value of the annuity unit. Therefore the following relationships are true concerning actual returns of the separate account and the Assumed Interest Rate (AIR):

	IF ACTUAL RETURNS ARE ABOVE "AIR"	IF ACTUAL RETURNS ARE BELOW "AIR"	IF ACTUAL RETURNS ARE SAME AS AIR
ANNUITY UNIT	INCREASES	DECREASES	REMAINS THE SAME
NEW BENEFIT PAID OUT AS COMPARED TO PREVIOUS US BENEFITS PAID OUT	INCREASES	DECREASES	REMAINS THE SAME

Example:

Mr. Wolf has owned an ABC variable annuity for 20 years and now wishes to annuitize to a monthly income. He has 10,000 accumulation units with a current value of $10 per unit for a total current value of $100,000 ($10 x 10,000). He chooses a variable payout method instead of a fixed or combination alternative.

The insurance company uses actuarial tables, Mr. Wolf's age and sex, an AIR of 5% and the variable payout selection in order to calculate the first payment amount. Based on all these factors it is determined that Mr. Wolf will redeem 50 units per payout. Since the current unit valuation is $10,

Mr. Wolf's first payment will be $500 (10 X 50).
In order for Mr. Wolf to keep receiving $500 per payout period, the actual return of the separate account must be at least 5% (to match the AIR).

If the value of a unit drops to $9 by the next payout, Mr. Wolf would receive $450 ($9 X 50) as his payment amount. On the other hand, if unit value increases to $11, his payment will equal $550 ($11 X 50).

Basic Taxation Concepts of Annuity include distinguishing between taxation of the insurance company and taxation of the annuitant.

Insurance companies are not subject to taxation on dividends and/or interest earnings from the separate account since these earnings are reinvested back into the account.

There is no taxation on capital gains realized by the account to the insurance company because, once again, these earnings are reinvested into the separate account.

Until an annuitant has constructive or actual receipt of earnings from a general or separate account, there is no taxation on the account during the accumulation period. Until earnings or capital gains are actually paid out, taxation is deferred. The reason behind this: capital gain distributions and dividend distributions paid from general or separate accounts have to be reinvested in order to buy more accumulation units.

Annuitants are subject to ordinary income taxation on the earnings or growth portion of the annuity once they receive the proceeds. If a client, owning a deferred annuity, makes random withdrawals from an account without annuitization of the contract, the annuitant is required to withdraw the earnings or growth portion of the contract first.

This is known as LIFO **or last in first out tax treatment when taking distributions.** (In other words, the first money d eemed to be withdrawn is income first and principal second and therefore all money withdrawn over the amount paid in, or cost basis, is taxable income.

There is also a 10% tax penalty on any money withdrawn over and above the cost basis for an annuitant who is less than 59 ½ years old at the time of that withdrawal. The sole exceptions to this 10% penalty are withdrawals in the event of death or disability. Annuitization, or the systematic withdrawal of the principal and interest in the form of regular lifetime periodic payments, not taken less frequently than annually nor beginning sooner than 60 months after the annuity start date, are also excused from the 10% penalty.

The IRS code sets forth tables which indicate the amount of taxable percentages applied against each benefit payment received. The portion of benefit which is over the cost base is considered ordinary income. Cost base for individual payments is calculated by dividing total cost base by life expectancy.

Matching Product to Client Need

The focus must be placed upon "who is the client?" The needs approach to planning demands that a planner grasp basic human nature tendency and identify the need characteristics of the client. This can only be accomplished by understanding who the client actually is. **It is the responsibility of the planner to ask the proper qualifying questions which will lead to need satisfaction.** Simply approaching clients and presupposing their needs without sufficient inquiry into their personalities and lifestyle is unacceptable from a proper planning approach.

Determine what is important to the client. The use of questioning technique is extremely important in ferreting out issues, both above and below the surface, which are important to the client. A useful technique is **the feedback technique**. In feedback, the planner listens to what the client is saying and then rephrases it, saying it back to the client who will then say "yes that is what I mean" or will clarify the true meaning back to the planner. **Clarification is an important tool** in fine tuning the exact nature of what is important to the client.

P**inpoint what the client sees as the role of insurance**. In helping to establish the importance of insurance in the financial planning process, it is crucial to discover what the client sees

as the role of his or her insurance coverage. From the life insurance point of view, a strong question to ask any client is **"What do you see your life insurance accomplishing for you in the event of your premature death?"** In this manner the client can tell you what he or she sees as the primary goal of proper insurance coverage. Does coverage supply cash to meet basic living expenses and cover a mortgage, or does it go beyond these boundaries?

What the client sees as important may be different from what the planner sees as important. The planner can point out additional roles the insurance may play, but it is always up to the client to have the final say in this area. If the planner asks the proper questions and supplies a good listening technique, a client will always indicate what he or she feels is both the best type of insurance and the correct amount for their current situation.

The need for consistent periodic review. It is critical for the client to understand that as their individual needs change over their lifetime, their protection package must adapt to meet those changes. From the life perspective, additions to family size, purchase of a larger home and an increased mortgage, or job

change with higher income are all reasons for increasing insurance coverage. To simply purchase one amount of insurance and never update is a sad mistake many people make in their lifetimes. Establish early in the client/planner relationship that periodic review on an annual or every other year basis is part of the service being provided. There will be no objection from the client in the future in discussing potential insurance needs which have changed and need to be adjusted. Of course these changes apply not only to the life area, but to the health, property and casualty areas as well.

Selected Business Insurance Topics: The Life Insurance Buy/Sell And The Basics of Pension Plan Formation

Regardless of the form of business entity, business continuation can only be achieved by careful planning. If survival is desired, the primary planning tool is the buy-sell agreement. This is true for proprietorships and partnerships as well as for closely held corporations, although it is most commonly used in connection with corporations.

In all buy-sell agreements, regardless of the form of the business entity, successful implementation of the arrangement depends on the availability of financing sufficient to implement the terms of the buy-sell. In most cases, the use of life insurance can provide the funding vehicle on which that success depends.

Elements of the Buy-Sell Agreement

A buy-sell agreement provides sufficient authority to continue the business in all cases following the death of the owner, whether the owner is a sole proprietor, a partner or the shareholder of a corporation (particularly a closely held corporation). It is the most common, and usually the most efficient method of providing for the orderly continuation of operation and transfer of ownership of the business entity. Use of such an agreement minimizes the risks inherent for survivors, heirs and estate administrators, and is preferable for creditors, as well.

General Nature of Buy-Sell Agreements

The buy-sell agreement is a contract which provides that one party will buy, and another party will sell, the outstanding ownership interest of another upon the death (or other triggering event) of the owner.

At the outset, the desire must be present for the business to continue. Assuming that such a desire exists, a preliminary step to creating a buy-sell arrangement, the proper party to continue the business must be identified. If the business is a proprietorship, the proper party may be another individual who will act as successor to the owner. If the proprietorship is operated and owned primarily by a single owner, identification of such a party may be difficult. If the business a partnership, identification of the proper party may be somewhat simpler, because the successor party will usually be the remaining partners. If the business is a closed corporation, the successor may be one or more of the remaining shareholders. In any case, identification of the proper successor is key to the success of the buy-sell. If the successor cannot be identified, there is no reason to attempt to implement the agreement.

Most often, the prospective buyer will be employed at the firm or will already be a copartner or shareholder.

Assuming that the desire for continuation exists, and that the successor is identified, a buy-sell agreement is crafted. The terms of such an agreement may vary, but generally will provide that the successor will purchase the interest of the owner upon the owner's death, retirement or other

triggering event (such as disability). The purchase price and terms will be clearly set forth, as well as the time frame in which the purchase is to take place.

Just as the buy-sell agreement is the preferred method of transferring control of a proprietorship to a chosen successor, the partnership buy-sell agreement is the best way to continue a partnership. The buy-sell has the advantage of being Pre-arranged and, unlike some other attempts to continue a partnership, legally enforceable. It also removes the possibility of conflicts of interest on the part of the administrator of the decedent's estate.

Like proprietorship buy-sell agreements, partnership buy-sell agreements are in the form of written contracts between partners under which the surviving partners agree to purchase the business interest of the deceased partner at a price set forth in the agreement. Alternatively, the business can be valued at the time of the triggering event according to a calculation set forth in the agreement. As is the case with proprietorships, it is critical that the successor partner be identified and be capable of, and motivated to, continue the business of the partnership.

As with proprietorships and partnerships, the preferred method for transferring control of a corporation is a buy-sell agreement. Normally, such agreements are for the purpose of t

transferring the stock of a deceased or retiring shareholder. However, similar agreements can be used to transfer title to assets.

In most respects buy-sell arrangements for corporations are similar to those for other types of business organizations. However, the great flexibility of ownership structure provided by the corporate form allows similarly increased flexibility in formation of the agreement.

As mentioned above, corporate buy-sell agreements can be any of several types. These include arrangements under which:

1) The corporation (or, if impossible, the surviving shareholders) must buy and the estate of the surviving shareholder must sell.

2) The corporation, or the surviving shareholders, has an option to purchase the stock of the deceased shareholder.

The estate has the right, but not the obligation, to offer the stock to the survivors or to the corporation. Normally, if the stock is offered, the offeree is obligated to purchase.

There is no obligation to buy or sell, but if a shareholder or his estate wants to sell, the shares must first be offered to the corporation or to the surviving shareholders before it can be offered to third parties.

The possible combinations are nearly without limit. However, as in other buy-sell arrangements, the success of the arrangement may hinge on identification of the successors, their motivation to continue the business, and their financial ability to purchase the stock.

The agreement itself can provide for the necessary funding by specifying the use of life insurance. Use of insurance to fund buy-sell arrangements is generally the most predictable and efficient way to guarantee the availability of funds.

Funded and Non-Funded Approaches

Another requirement for the success of a buy-sell arrangement is provision for <u>funding the agreement</u>. Such provisions are commonly included in the written buy-sell contract. The reason that funding must be provided for is obvious--it would do no good to require the purchase and sale of an ownership interest if, when the time for performance

came, the buying party could not perform due to lack of funds. Thus, the contract may attempt to provide funding in advance. Normally, life insurance is the vehicle which is used to provide the required funding.

Funding with life insurance is more valuable than unfunded arrangements which may come immediately to mind because it provides the buyer with greater flexibility, and with the assurance of availability of capital. For example: the buy-sell terms provided that the buyer pay for the seller's interest out of the proceeds of the business, the buyer will be deprived of income during the repayment period. Similarly, payment of loan balances and interest to a bank would impact the employee's income, even assuming he could qualify (or prequalify) for such a loan. Payment of the price to the owner or his heirs in installments would be unsatisfactory because during the installment period the owner would be deprived not only of ownership, but also of the value of the ownership interest being sold.

Life insurance, if used properly, can provide funding sufficient to meet the purchase price requirements. It will guarantee the delivery of the proper quantity of money at the time it will be required. When used in this way, the buy-sell agreement is said to be <u>funded.</u>

The funded buy-sell agreement between the sole proprietor and one or more of the key employees of the

business, benefits all concerned: the employees, since they will succeed to ownership of the business; the family of the deceased sole proprietor, since they will receive a fair price for the business; and the proprietor himself since his creditors of the business and the employees know that there is an orderly plan for continuation of the business.

Typical Provisions

The terms of buy-sell agreements vary depending on the type of business entity, the parties, the price, the timing and the funding and payoff terms. However, certain provisions are typically included in nearly all buy-sell agreements. These terms include identification of the parties, a statement identifying the business by name and location, and the agreement of the parties to purchase and sell the business upon the death of the owner, identification of the assets and liabilities of the business, and the price of the transaction.

Commonly, provisions for funding the transaction through the use of life insurance contracts are also included. Such a form is capable of adaptation for use in the case of proprietorships, partnerships or corporations, as well.

Entity Valuation

There are several methods of valuing ownership interests. The purchase price is usually based on the value of the assets and the goodwill less the liabilities of the business. Assets are real and personal property, and financial assets such as receivables and cash on hand. Goodwill is the good name and reputation of the business entity. Goodwill is often quite important to the valuation calculation. It is sometimes embodied in intellectual property, such as trademarks, trade names, and trade secrets. Just as often, however, it is the good reputation which the business has earned over time. Liabilities are accounts payable and recurrent expenses.

Typically, in a buy-sell agreement the price of the purchase is clearly stated in the agreement. Because the value could change over time, the agreement normally provides that revisions in the price can be made from time to time.

Obviously, for such a revision to become enforceable, it must be documented in a written amendment to the contract document and agreed to by both parties. The price can be arrived at by any of several methods. Most of these employ a valuation formula.

One method is simply to state a fixed price per share for the decedent's stock, agreed to by both sides. This is the most common method.

Considerably less security is provided if the valuation formula depends on an appraisal at the time of the death or triggering event.

A more sophisticated valuation formula includes calculation at the time of death of adjusted book value of the business. Book value is normally assets less liabilities. However, book value enhances the calculation by taking into account adjustments for asset depreciation and current market values of assets which might otherwise be carried at unrealistically low values.

Another formula is based on capitalized earnings of the business. This method is less direct. It involves calculating the earning ability of the business. This is shown by the profit and loss statement, and comparison of the business' earnings to similar businesses. From this comparison, average earnings are calculated. This average earning is then multiplied by a capitalization factor. The capitalization factor often is a multiplier of between 5 and 15. This calculation requires considerable sophistication in valuation theory and technology, along with knowledge of the industry.

Many other methods of calculating the value of the business can be used. These include calculation of a price based on the straight capitalization method, in which the corporation's average net profits are capitalized at a specific rate, and the result represents the total value of the business including the goodwill. A typical capitalization rate is 10-15%. Combinations of several methods may also be used.

Obviously, any calculation formula may be dynamic over time. Thus, if funding is to be provided with life insurance care must be taken to see that the policy values track the calculated value.

Application of Life Insurance

Using life insurance to fund the buy-sell arrangement is the most efficient and convenient method of assuring funding or the transaction will be available when it is needed. If insurance is used, provisions in the agreement spelling out the plan in detail are critical to its ultimate success. These include:

Provisions identifying the policies used. Policies must be identified by issuer, policy number, the name of the insured, the face amount of the coverage, and a statement that the proceeds are to be used to purchase the ownership interest.

Provisions for adding and changing policies. Arrangements to add policies or coverage amounts are necessary. This reflects the dynamic nature of the valuation, as discussed above.

Provisions covering differences between the amount of insurance and purchase price. If the value of the business changes faster than the coverage can be adapted, there may be a difference between the price and the proceeds available. For example, if the amount of coverage is not equal to the price, the buyer could be required to pay the difference in installments over a time period. Such a schedule should be spelled out.

Ownership and premium responsibilities. Normally, the prospective buyer will own the policy. The policy will cover the life of the owner, partner or principal shareholder.

Beneficiary arrangements. The prospective buyer is typically the beneficiary of the policy.

Disposition of the policies upon termination of the agreement

Generally term insurance rather than cash value life insurance is used to fund buy-sell agreements. At some point, due to the constantly increasing cost of term life insurance over time, conversion to a level premium policy may be a consideration.

Sole Proprietor Tax Considerations

In the case of a sole proprietorship or partnership, the business entity has no legal existence apart from the owner. Therefore, the value arrived at for purposes of the buy-sell arrangement will be included in the value of the owner's estate after his death. Assuming that the calculation can be supported by reasonable assumptions and methods, the Internal Revenue Service will usually accept it as valid.

Funded Buy-Sell Agreements (Partnerships)

Nearly all of the factors discussed in the preceding section apply to buy-sell agreements for all types of business organizations including partnerships. However, partnership buy-sells may present additional considerations.

There are two types of partnership buy-sell agreements. Entity purchase agreements provide for the partnership itself to purchase the interest of the deceased partner. In the case of

entity purchase arrangements, the partnership itself owns life insurance contracts on the life of each partner. The partnership, likewise, would be the beneficiary of the insurance contracts in the event of any partner's death. The funds from the life insurance indemnity are then used to purchase the partner's interest at a price, which is either predetermined or calculated, as set forth above.

Cross-purchase agreements, on the other hand, are more commonly used where there are only a few partners. The partners arrange to buy each others' interests. The partnership itself is not a participant in this arrangement. Each partner owns and is the beneficiary of life insurance on the other partners. Rather, each partner purchases life insurance on the other partners, pays the premiums and is the beneficiary. The funds are used to fund the purchase of the deceased partner.

To the extent that either arrangement is used and properly funded, the heirs of the deceased partner, the remaining partners, and the creditors and customers of the business are all benefited by such an arrangement. The heirs are advantaged because they know with surety that they will receive a fair price for the partnership share. The creditors and customers are advantaged by knowing that there is an orderly plan for the continuation of the partnership's business.

The remaining partners benefit by the knowledge that their source of income will continue, and by their opportunity to increase their stake in the business. Also, they are not subject to the possibility that they will be forced to take on a family member as a partner, or that any other unusual conditions may ensue from the death of the partner.

Entity Purchase Agreements (Liquidation Plans)

If the entity purchase arrangement is used, the partnership itself will purchase the share of the deceased or retiring partner. In some ways, the entity purchase arrangement is similar to a corporate stock repurchase plan. However, partnership plans present different problems.

Elements of Decision Assuming that the agreement is funded by life insurance, the partnership itself will own the policies, pay the premiums and be the beneficiary. Obviously, for planning to be complete, there must be life insurance policies on each partner. Therefore, the number of partners is one of the elements in the decision of what type of arrangement to use. As the number of partners increases, entity purchase arrangements become more attractive due to the cost savings resulting from the smaller number of policies required. (See succeeding discussion on cross purchase agreements).

Similarly, the age of the partners is an element in the decision as to which type of arrangement to use. At the early stages of a partnership's existence, when there may be only a few partners and they are likely to be close in age, this may not be an issue. However, if the partners are not close in age, it can become one, even if the entity form of agreement is used. This is because life insurance on older employees has considerably higher premium costs that on employees who are relatively younger. If the individual partners owned and paid the premiums on life insurance covering their copartner, the younger partners would therefore incur greater premium expense. This would be an argument for use of the cross-purchase style of arrangement.

The *interests of the different partners* are also weighed in making the decision. This analysis is similar to that regarding the age of the partners. If the partners own similar shares of the business, it is not an important element. However, if the partners own disparate percentages of the business, this could become material. The partner who owns the larger percentage would be more expensive to buy out, necessitating more life insurance to be carried on him by his junior copartner. The junior partner then incurs the greater expense. This result may lead the partners to consider the entity purchase type of plan, in which the business itself owns the life insurance.

A consideration in entity arrangements is that when the partnership owns the policies the value of those policies, including any cash value which may accrue (which is unlikely, since most of these agreements are funded with term insurance), is an asset of the business. Although all assets of the business contribute to the value of the business, they are also available to creditors. Avoidance of this situation would be an argument for adoption of a cross-purchase arrangement.

Under the entity arrangement, the business uses the proceeds of life insurance policies on the deceased partner to purchase the deceased partner's interest. The share of the deceased partner is retired into the business. Since the business itself is the buyer, the result is that, somewhat ironically, the sum of the surviving partner's shares following the entity purchase may not equal 100%. For example, if a partnership of three equal partners (each with a 1/3 interest) purchases the share of one of them, the remaining two partners are still left with two equal shares of 1/3 each. Normally, the surviving partners will reorganize the partnership following the buyout.

Tax Considerations

There may also be tax considerations which play a part in the decision of which type of arrangement the partners should use. For example, under Section 708 of the Internal Revenue Code, if more than 50% of the partnership capital and profits are sold within a 12 month period, the partnership must be dissolved. However, if the interest of the partner is liquidated, there is no dissolution even if that interest exceeds 50%. Part of the liquidation payments can be made tax deductible to the remaining partners and payments for goodwill can specifically be made tax deductible to them.

Payments made in liquidation of the decedent's partnership interest are considered distributions by the partnership to the extent that the payments are in exchange for the partner's interest in partnership property. These provisions do not apply if the transaction is between the parties. For this reason, tax considerations may be an element in deciding which form of transaction to use. However, even though the IRS could argue that each partner has incidents of ownership in the insurance used to fund such a transaction because of his management rights as a partner, the Service has never taken this position, and the risk that it will do so is regarded as slight.

Cross Purchase

A cross purchase agreement is used in situations where there are just a few partners. One reason is that such a plan is more expensive to implement because of the number of insurance policies which must be purchased. In essence, each partner insures the life of all the other partners, with himself as beneficiary. The partnership does not participate in the transaction directly.

Due to the expense, the cross purchase arrangement is usually not workable if there are more than three or four partners. For example, if there are two partners, A owns insurance on B, and B owns insurance on A, so a total of two policies is required. Where there are three partners, A owns policies on B and C, B owns policies on A and C, and C owns policies on A and B. Thus, six policies are required. Generally, the number of policies required is

$$P * (P-1),$$

where P is the number of partners. Thus, in a 4 man partnership, twelve policies would be required, while if there are five partners twenty policies would be used. It is easy to imagine that the cost quickly becomes prohibitive as the number of partners increases. For that reason, the cross purchase arrangement is seldom used for larger partnerships.

Components of the Funded Buy-Sell

The components of the funded buy-sell agreement for partnerships are similar to the components of similar agreements for sole proprietorships and, to a certain extent, for corporate forms. An outline of typical terms follows below.

The agreement binds the partners and the heirs to the purpose of effecting the buy-sell. In addition, it normally binds the partners to a refusal option in the event that a partner decides to leave the partnership during their lifetimes. The purchase price will be set, the use of life insurance to fund the purchase will be provided for, and the disposition of the decedent's interest in the partnership is also set forth in the agreement.

The following is an outline of the principal terms, although the agreement can set forth more, or fewer.

Parties

All of the partners are parties to a cross purchase arrangement, since each partner will end up owning insurance on the life of all the other partners. If the entity purchase arrangement is used, the partnership itself along with the partners, will be an additional party. Generally, each partner is

identified by his full name and residence address at the time of the agreement, and the partnership by its formal number, office address and tax identification number. These identifications are normally set forth either in the preamble to the agreement or in a special definitions section.

Identifying the Purpose

The primary purpose of the agreement is to provide for the orderly transfer of the decedent's interest in the partnership, either to the partnership as a redemption, or to the surviving partners. If a redemption-type of transaction is planned, the entity-purchase arrangement is used. Purchase of the decedent's interest by the remaining partner or partners requires use of the cross-purchase style of transaction.

Options at Retirement or Resignation

Just as the partners wish to plan for continuation of their business upon the death of any partner, they also wish to plan for the eventuality that a partner may retire or resign from the partnership. Normally, the partners desire that, in such an event the retiring or resigning partner offer his interest first to the remaining partner. The buy-sell agreement normally

contains provisions to this effect. Not uncommonly, this option provides either the remaining partners, or the partnership itself, with a right of first refusal to purchase or redeem the interest of the retiring or resigning partner.

Determining Price and Funding

Price

As in the case of sole proprietorships, and as discussed above, the price of the transaction must be set clearly forth in the agreement. If it is not, the lack of clarity is likely to ultimately defeat the purpose of the transaction. Setting a specific price provides clarity, and all parties to the agreement have the benefit of that for planning purposes. However, use of a stated price has several disadvantages. Primary among them is that even if the agreement provides for it, the business may not review and update the price with adequate frequency o assure that the price reflects the value of the business at a given point in time.

Likewise, the price must be a fair one, or the heirs of the decedent will be disadvantaged and may be motivated to challenge the legality of the proposed transaction. As set forth above, there are numerous methods of valuation which can be employed to arrive at a price which is perceived as fair.

Such concerns may dictate the use of a valuation formula, as discussed above. The formula could provide a value calculation based on appraisal, adjusted book value, capitalization of earnings, or any of the other techniques discussed previously, or a combination of them. If a valuation formula is used to set the price, the agreement should also specify who shall perform the calculation, the method of calculation, and the times at which the calculation will be performed.

An obvious disadvantage of valuation formulas is that, since the value of the business will be established at the time of death, it is not possible to predict with absolute certainty the amount of life insurance which will be necessary to fund the transaction. Assuming that the transaction will be funded with life insurance contracts (regardless of whether the entity purchase or cross-purchase plan is used), the provisions for obtaining, owning, paying the premiums and designation of beneficiaries should be clearly set forth in the agreement. All insurance policies should be identified by number, owner, amount, date and beneficiary. This is usually done on a chedule attached to the agreement itself, since the schedule is simpler to keep up to date. The insurance provisions of the contract should also lay out plans for the acquisition of additional insurance, substitutions of owners or beneficiaries, and making other changes regarding the insurance contracts.

Professional Services Partnerships

If the partnership is in the business of delivering professional services, such as a law firm or a medical practice partnership, valuation of the business is more difficult, because there are few hard assets upon which the valuation can be based. Thus, valuation formulas based on an assets + goodwill calculation are difficult or impossible to perform. Assets of professional practices largely consist of intellectual property and goodwill.

ere the need for a funded buy-sell agreement may be even more evident than for a normal partnership. The professional partnership will require capital in order to service the client load of the decedent, and the decedent's family will have a requirement for substantial funds to replace the income which would have presumably been earned by the decedent.

The usual solution for a professional partnership is to employ an entity purchase form of arrangement. This is especially so for professional partnerships which have a multiplicity of partners. Some law firms, for instance, have over 500 partners. Use of cross-purchase arrangements would be practically impossible for such a partnership. One provision often employed by professional partnerships in their buy-sell agreements provides continuing income to the family of the deceased partner rather than a lump-sum.

Beneficiaries

As noted above, the beneficiary arrangements must be set forth in the agreement. Typically, in a cross-purchase arrangement, the individual partners are the beneficiaries. In an entity plan, the partnership itself is the beneficiary. (Note that for tax purposes, payments received from insurance policies by the partnership will increase the value of the partners' percentage interests). If necessary, the beneficiaries f all policies could be a trustee. However, use of a trustee will increase the complexity of administration.

Use of Insurance

Premium Selection and Payment

It was noted above that premiums on life insurance contracts are normally paid (and the policies owned) by the partners, if the contemplated transaction is of the entity purchase type, and by the partnership itself if the cross-purchase arrangement is used. However, other arrangements may be made. How the premium payments are allocated should be spelled out in the agreement, since calculation of the allocation can be somewhat complex.

This is because many of the same factors discussed above may apply. The partners may all have equal interests, or they may not. There may, or may not be great disparity in age. As set forth above, inequities may result if all eventualities are not planned for from the outset.

Consider a three man partnership with a cross purchase arrangement and equal partnership interests where the partners are all equal in age. Each partner owns policies on the other two partners. Each is responsible for two premiums, since he does not pay for the insurance on himself. In such a case, the premium costs would be effectively equal, and the relative burdens would also be equal. However, if one partner is substantially older, the premium cost for policies on him will be proportionally greater. Similarly, if one partner has a proportionally larger share, the insurance required to provide the necessary funding for his share will be proportionally larger, resulting in higher premium costs. The higher costs borne by the other partners result in an imbalance. The best way to deal with such an imbalance is to address it in the buy-sell agreement.

The premiums could be pooled, and then paid in equal shares by the partners. A disadvantage of this approach is that

the pooling will cause the more junior partners to pay a disproportionate share of the total premium. For this reason, pooling of premiums, is not normally used where ages or partnership interest shares vary.

Alternatively, the insured partner could pay the premium on the policy covering his own life. This arrangement typically is found only in cross purchase agreements involving only one or two partners.

When the partnership pays the premium, as it would under an entity purchase arrangement, any cash values which accumulate under the policy become assets of the partnership, and therefore or the partners. As such, the cash values are potentially subject to the claims of creditors. This is often reason enough to utilize term insurance for purposes of funding these agreements. Cash value insurance, however, has several uses and can be valuable to a business in any of several applications.

Application to the Partnership

An additional clause relating to insurance may specify what becomes of policies on the lives of the surviving partners if there has been a transaction under the buy-sell agreement caused by the death of one of them. Normally, this occurs only in the context of cross purchase arrangements.

For example, suppose in a three person partnership each partner owns and is the beneficiary of insurance contracts on the life of the other two partners. If partner A dies, partners B and C receive benefits which are used to purchase A's interest from the heirs. Thus the heirs are paid the stated price for their forbear's interest, and B and C remain as partners. Each still owns insurance on the life of the other, and the estate owns policies on each of them. The agreement may wish to provide that those policies terminate, with the cash values paid to the estate. If the partnership continues in operation, there need be no change in the partner's policies, except that the amounts of insurance may need to be increased. However, if the partnership terminates, the insurance contracts will likely terminate. If this is the case, accumulated cash values on them should be paid to the owners.

Adjustments to the Plan

As mentioned previously, the agreement can, and should provide for amendments and changes as they become necessary, particularly to the value of the business as reflected in the price. The value of the business, and therefore the price, will change over time regardless of the valuation formula used, as will the value of a proprietorship or a corporation. The agreement must be capable of amendment to reflect such changes, including changing the amount and type of insurance policies used, if necessary.

In addition, the agreement should state the procedure to be used for payment of the price if the value exceeds the amount of insurance available at the time of the death of the partner. Normally, the agreement will provide that any unpaid balance will be paid in installments, with reasonable interest, by the surviving partners. Usually the time frame for completion of the payment is relatively short.

Tax Considerations

As noted above, the partnership is not a separate taxpaying entity, although it does file an annual return. Rather, partnership profits are passed directly through to the partners in the proportions of their partnership interests. The partners are taxed on their respective shares of the profits.

The premiums on life insurance to fund buy-sell agreements are not deductible. This is the case whether paid directly by the individual partners pursuant to a cross-purchase agreement, or by the partnership itself to fund an entity purchase. However, the value of the partnership interest of the deceased partner is included in his estate for federal estate tax purposes. As with any business interest, the Internal Revenue Service usually will accept the valuation set forth in the buy-sell agreement if the assumptions used in the process of valuing the business are reasonable.

Funded Buy-Sell Agreements for Close Corps

Participants in a new corporate venture should employ a buy-sell agreement to provide for continuation of the business upon the death of one of the participants, and to provide the surviving participants with the opportunity to buy the interest of the decedent. In a corporation, that interest is reflected in the proportion of shares owned by the decedent. Employment of such an agreement benefits the surviving shareholders, whose investment in the business is protected to the extent that the business' opportunity to continue is enhanced. The family of the deceased shareholders is also benefitted by virtue of the fact that they receive a fair price for the value of the investment.

Virtually all of the concerns discussed above with regard to partnerships also apply to buy-sell agreements in the context of closed corporations, including the form of the transaction, valuation and pricing, funding (usually through the use of insurance contracts), funded/unfunded approaches, tax considerations, and typical provisions. This section investigates those considerations.

Types of Agreements

●Typically, corporations will utilize buy-sell agreements structured to:

●Require the corporation to buy, and the estate of the deceased shareholder to sell;

●To provide the corporation or the surviving shareholders with the right, but not the duty, to

●purchase the shares of the deceased shareholder;

●Provide the estate with the right to sell the stock to the surviving shareholders; or

●Require the estate to offer the shares first to the surviving shareholders.

In structuring the agreement, a number of forms can be used. Many are similar in nature to the entity purchase or cross-purchase arrangements commonly utilized by partnerships in their business continuation plans. Examples include:

1) Agreements between the business itself and the individual owners (similar to a partnership entity plan);

2) Agreements between the individual owners (similar to partnership cross-purchases);

3) Agreements between individual owners and key persons, such as family members or third persons; or

4) Combinations of the above.

The determination of which form of the plan to use is driven by several factors. These include: the number of shareholders; the desire to shelter accumulated cash values from creditors of the corporation; the ages and relative interests of the shareholders; and tax considerations. In the case of closed corporations, the most commonly used plans are stock redemption plans which act to reduce the number of shares which are issued (although the number approved remains unchanged).

Stock Redemption (Entity Purchase) Agreements

At the death of a shareholder, his stock passes to his estate. Life insurance proceeds from policies on his life are paid to the business. The business pays the cash proceeds to the estate according to the agreement. In response, the executor of the shareholder's estate transfers the stock to the corporation. This form of agreement is similar in nature to the entity

purchase agreement commonly used by partnerships and is known as a stock redemption agreement. The number of shares of authorized stock remains unchanged, but the number of shares issued has been reduced. Consequently, the remaining shareholders have an increased percentage of the issued voting stock.

In order for the plan set forth in the agreement to be successful, a definite price for the stock must be arrived at and the transaction must take place at the established price. The price is normally arrived at by any of the established valuation methods discussed previously. The transaction is enabled by the funds provided by the life insurance policies used to fund the transactions. As with partnership arrangements, plans that fit these parameters are known as funded buy-sell agreements.

If the corporation was both the owner and the beneficiary of the policies used to fund the agreement, the value of the insurance on the decedent's life will not be includible as insurance proceeds per se in the decedent's gross estate for estate tax purposes. Similarly, premium costs paid by the corporation on insurance used to fund the agreement are not tax deductible to the corporation. Similarly, the proceeds are received by the corporation tax-free. Assuming that all of the shareholder's stock is terminated, the transaction will not be treated by the IRS as a dividend distribution. See the discussion on taxation issues below.

Cross Purchase Agreements

The cross purchase arrangement for closed corporations is similar in nature to that for partnerships. It is used in similar circumstances--that is, where there are few shareholders who are also active in the management of the corporation. In the cross purchase form, each shareholder is insured for the value of his share. The policies are owned and premiums are paid for by the other shareholders. The owners are the beneficiaries of the policies. Upon the death of a shareholder, the proceeds of the life insurance on his life are paid to the shareholder-policyholder-beneficiaries. The money is then used to purchase the interest of the decedent.

As in the case of partnerships, if there are more than very few shareholders, usually two or three, use of this form of agreement becomes expensive and awkward due to the number of insurance policies which must be maintained. Thus, if there are more than just a few shareholders, the entity purchase agreement is normally used.

However, many other elements play a part in the decision of which form to use. Among these are the relative ages and membership interests of the shareholders. Disparity in either

would result in inequality of premium payments. If the premiums were being paid by individuals under a cross purchase plan, these inequalities could be a cause of dissatisfaction with the agreement. Therefore, if the shareholders are greatly different in either age or relative ownership, the entity purchase form would be preferable if equalization of premium payment is a concern.

Tax considerations are also present. As with the entity purchase form, life insurance premium payments on policies used to fund the agreement are not deductible by the stockholders. The fact that the stockholders are responsible for the premium payments is, in fact, one of the major drawbacks of this type of agreement. By using split-dollar insurance, the corporation can help finance the buy-sell plan.

A final consideration in deciding what type of agreement to use is enforceability of the agreement. Cross purchase agreements are clearly enforceable, while entity purchase plans may not be enforceable if the corporation has insufficient surplus to make the purchase (something that is unlikely to occur if the transaction has been funded with life insurance). Funded agreements are normally enforceable.

The Basics of Pension Plan Formation

(Business plans that are qualified and nonqualified, and defined benefit versus defined contribution plans)

Nonqualified Contributions - Plans which are nonqualified exist for the individual and/or can be established through corporations as employee benefits. **There are no special tax benefits offered under nonqualified plans and contributions are made with after tax dollars** (meaning they cannot be deducted by the individual, employer or corporation under most circumstances). The contributions of employers who contribute on a nonqualified basis are not deductible until established contributions have been transferred (taxable) to the employee**. Upon receipt by the employee, benefits are taxable as ordinary income.**

Deferred annuity contracts and qualified plans were placed on a more equal basis with each other under the tax reform act of 1986. When an annuity contract is not owned by an individual (owned by the business or the corporation), annuity **contract growth is taxable to the corporation during the taxable year.** In this circumstance, an annuity is not considered an annuity under tax law for this circumstance.

Nonqualified plans, or plans in which contributions are not tax deductible, include such things as periodic reduction and deferred compensation programs:

*** **Payroll Reduction Plans** - deductions are made from employees' paychecks on a systematic basis. After tax has been deducted from the employee's income, a prescribed amount of remaining income is deducted and invested into a number of investment vehicles available to the employee, at his or her option.

A common plan utilized by the payroll deduction method is the annuity. Since the annuity is a nonqualified retirement plan for an individual, the annuity product provides growth on a tax deferred basis.

*** **Deferred Compensation** - Deferred compensation plans do not require IRS approval and therefore the plan may discriminate between employees. **Deferred compensation plans are either funded or unfunded.** It is irrelevant whether or not the plan is funded because the employers do not get to deduct contributions until payments are made to employees.

A written agreement must exist between the employer and employee to defer receipt of the money until after retirement, disability or death. If the program is funded, any income taxes which are deducted are employers paid. Once the

employee has retired, he or she receives the deferred payment as ordinary income. **Under deferred compensation employees usually get no benefits until retirement.**

This method is not without risk since, if a business fails, an employee must stand in line as a general creditor of the business and there is no guarantee that the employee will ever receive any deferred payment amounts.

*** **Employee Thrift Plans** - Employee thrift plans can be either qualified or nonqualified. In this instance, an employee takes a salary cut on either a deferred taxation basis if the plan is qualified, or a salary deduction after taxation if it is nonqualified. **Normally the thrift plan involves some form of employer matching contributions**. Although the employee's contribution is immediately vested, the employer's contribution may or may not vest immediately.

Tax Deferred Growth - Normally any income or dividends earned on investments are taxable to a recipient taxpayer within the normal tax paying year, at ordinary income rates. However some nonqualified plans, such as an annuity, allow the investor to enjoy income growth on a tax deferred basis. This means during the accumulation phase of

an annuity the income, or growth portion paid upon principal investment, is allowed to accumulate in a manner shielded from income taxation until receipt of the principal and/or interest is received at a later point in time.

In the case of nonqualified plans, the money being used to fund the annuity is after tax income. In a qualified plan, the money used is deducted from current taxable income and is known as "deferred tax dollars."

Qualified Retirement Plans - Business

*** **ERISA**, also known as the Employer Retirement Income Security Act, was passed by congress in 1974 and was designed to regulate the retirement plan business. Certain minimum standards in reporting requirements were established. ERISA was supposed to protect the interest of employees and their beneficiaries by defining certain standards. These standards include:

--- **Beneficiaries** - Plan participating spouses are given greater protection because of a joint and survivors provision which assures payment if the spouse of the plan participant outlives the plan participant.

--- **Fiduciary** - Retirement funds must be handled on an approval basis.

--- **Participation** - Retirement plan eligibility must be reasonable so that an individual can qualify for plan participation.

--- **Reporting and Disclosure** - Employees and beneficiaries must be aware of their rights under the plan. Annual reports used to explain the employee's status must also be available.

--- **Funding -** Prescribed provisions must be met in order to assure money is available to pay the benefits earned at retirement.

--- **Vesting** - Minimum periods for qualifying for participation must be established in order to assure that the employee will receive some type of benefit at retirement.

*** Keogh (non-corporate)

The Keogh law or HR-10 (house rule -10) is designed to set up rules for establishment of qualified retirement plans for self-employed individuals (who are not incorporated) and their employees. Those people who are eligible may accumulate

retirement savings on a tax deferred and tax deductible basis. Subject to sufficient qualifying income, an individual establishing a Keogh may also make contributions to an IRA. Keogh funding may be accomplished through investments and stocks, mutual fund annuities, bonds, and life insurance policies that provide retirement income.

Funds utilizing collectibles are not allowed (coins, antiques, etc.) for a contribution. Plan assets may be held in trust in a special custodial account at a bank or through an annuity contract available from life insurance companies.

Two general types of contributions are defined benefit and defined contribution. A **defined benefit** plan means that a predetermined benefit will be provided to a participant **and the contribution to such a plan is based on an amount necessary to provide the benefit desired.**

A **defined contribution** plan establishes an individual account for each participant and the **eventual retirement benefits depend upon how much is contributed** to that plan each year.

Under the Keogh rule for defined contribution plans, contributions are limited to the lesser of $30,000 or 25% of earned income. Earned income is defined as gross income minus the contribution made to the retirement plan.

Defined benefit plans under Keogh state that contribution limits cannot exceed an amount necessary to provide retirement benefits as specified in the tax code. **Keogh plans are not qualified if contributions are discriminatory in favor of officers or highly compensated employees**. The plan is deemed to be nondiscriminatory if contributions are uniform in relationship to total compensation or regular rate of compensation as to employees. In other words, an employer has to contribute the same percentage to each covered employee's plan as he does to his own plan. However, in no event may more than 30,000 or 25% of earned income be contributed.

Eligibility for Keogh and corporate retirement plans are:

►1 year of service (1000 hours paid hours) and
►participants must be at least age 21.

Additionally, Keogh plans may require up to 3 years of service when 100% vesting occurs right away.

Contributions may be allowed on a voluntary basis, by **the employee**, into the plan. Such contributions, of course, are made in addition to employer contributions. Contribution **limits are 10% of compensation and the contributions are made after tax and are not tax deductible**. However, the contributions are allowed to accumulate on a tax deferred basis. Please note: since voluntary contributions are made with after tax dollars, these contributions cannot be rolled over into an IRA or other qualified plans. However, the deferred growth portion (income earned on the voluntary contributions) can be eligible for a tax-free rollover.

**** Corporate Retirement Plans** - In a manner similar to Keogh plans, corporate pension or profit sharing plans also have rules and regulations for eligibility for vesting, relative to contributions made. The main distinction between Keogh and corporate plans are the limitations on withdrawal: corporate plans must place restrictions on early withdrawal benefits and distribution must be paid at retirement.

The 10% and 50% penalties under IRA and Keogh plans (for early and late withdrawal, respectively) also apply to corporate retirement plans. Additionally, excess contributions over and above those allowed by law are subject to a 10% percent penalty. Taxation as ordinary income when received by the participant is the general tax rule that applies to the benefits.

--- Profit Sharing Plans - Profit sharing plans are a type of defined contribution plan available to corporations. A percentage of profits are to be contributed for the benefit of employees. The percentage is determined by the employer.

In a profit sharing plan, contribution is not mandatory and this factor separates profit sharing from other types of corporate retirement plans. Contributions to the plan are mandatory however for defined benefit or defined contribution plans once a contribution is determined and some formula is applied. **Under profit sharing, the board of directors of the corporation decides the contribution to be made.**

SECTION V:
The Value of Money Over Time

Understanding "opportunity cost" - Opportunity cost is deciding the best thing to do with your money in order to receive the greatest benefit. In terms of waiting for money, it is always better to receive money as soon as possible so that it may be put to the best use possible**. The longer you would wait for money the more opportunity cost you would realize. Having the ability to put money to work in the nearest possible time frame would minimize opportunity cost.**

On the other hand, having to pay money out to someone else would result in a person wanting to delay that experience or as long as possible (don't make payments to creditors until absolutely necessary). The longer you can wait before you have to pay a sum of money, the better you can realize the return on that money while you hold it. **The earlier you pay money, the greater the opportunity cost you realize.**

The best possible use of money is a problem that plagues almost any individual. Weighing the safety of a return

against the amount of the return creates the **"investment dilemma"** we all share. By using money in one way versus another, we will incur an opportunity cost if we could have --invested at a better (higher) rate elsewhere.

The Interest Rate- The concept of an interest rate allows us an ability to view opportunity cost in numerical terms. In comparing one investment to another, the application of an interest rate will allow us to easily evaluate one return with another**. Interest** rate application **can be simple** or much more complex (**compound** interest).

Simple Interest. As its name implies, this is the easiest interest rate application. For calculating simple interest, just – **apply an interest rate** percent **only to an original sum of money**. Compounding is not considered when dealing with simple interest.

Compound Interest can be calculated by **applying an interest rate to the total of original principal sums plus the interest that was credited to it in earlier periods of time.** A good example to highlight the difference between simple and compound interest is as follows:

If you assume you are investing $1,000 in a bank account which earns 6% simple interest each and every year, that $60.00 interest would be credited at the end of each year.

At the end of five years $300 will be credited to our account assuming no withdrawals have been made. Just add

60 + 60 + 60 + 60 + 60

and you understand the application of simple interest.

However if the account earns 6% compound interest each and every year, it will grow to a significantly larger amount. This is because we are adding, to the original principal sum of money, the amount of interest that was earned in a previous period and then we are applying the interest rate to that total amount.
Therefore:

$1,000 X 1.06 (6)% = $1,060); $1,060 X 1.06 = $1,123;
$1,123 X 1.06 = $1,191; $1,191 X 1.06 = $1,262;
and So $ $1,262 X 1.06 = $1,338

Under compound interest, our principal sum is accumulating at a greater rate than it would with simple interest. Using the above example, your account would have $1,338 at the end of 5 years with compound interest and only $1,300 with simple interest. **Which amount would you rather have?**

The Frequency of Interest Rate Calculation.

Another factor which must be considered in our return (and ultimate opportunity cost) is the number of times an

interest rate is applied in any given period of time. **Interest can be applied on an annual basis or much more frequently** (for example, twice a year, quarterly, monthly, or perhaps even daily).

We must recognize that, all other factors remaining the same, the more often we compound (or discount) the greater (or less) the effect will be on the growth of the future value (present value) of our sum of money.

The main reason a sum of money becomes greater when we frequently compound is **the more frequently we add interest and make that a part of principal, the greater the principal amount we have to work with.** In this manner, future interest rate applications will yield only greater and greater amounts compared with less frequent compounding.

Present and Future Value.

Future value is determined by taking the present value of a sum and increasing by some known rate of return. In multiplying a current sum by a given rate of return, over various periods of time, **we can determine what the future value of today's sum** of money will be at some specified

future point. The mathematical formula for calculating the future value of a single sum of money is as follows:

$$FVSS = PVSS\ (1 + i)^{n}$$

where:

FVSS = the future sum of a single sum
PVSS = the present value of a single sum
i = the compound annual interest rate (expressed as a decimal)
n = the number of years or time period during which compounding occurs.

The Internet has many good websites including (http://www.finance.cch.com) where you can find present and future value tables and calculators. Also, a good financial calculator available from any electronics or office supply store can also be used for this purpose

An example of applying this FVSS formula appears below:

How much will the single sum of $1,000 grow to in 5 years at 6% annual interest?

$$FVSS = PVSS (1 + i)^n \quad \text{or} \quad FVSS = \$1{,}000\ (1+.06)^5$$

$$= \$\ 1{,}000 \text{ X } 1.3382 \ = \ \mathbf{\$1{,}338.20}$$

NOTE: by using the factor from a"Future Value of a Single Sum" table, will find the factor of 1.3382 at n=5 under the 6.0% column. This type of table will save you the work of multiplying the product of 1.06 X $1,000 a total of five times.

Alternatively, if we want to determine the present value of a future single sum of money and determine what it is worth today, we need to reverse the process.

EXAMPLE: IF WE NEED $100,000 IN 3 YEARS AND CAN EARN 10% ANNUAL COMPOUND INTEREST, HOW MUCH MONEY DO WE NEED TO INVEST TODAY?

$ 75,131.48

The simple method of arriving at the answer in the above example would be to locate and use a "Present Value of a single sum" table (or a financial calculator) By looking directly under a 10% column and crossing your finger at 3 years (n=3) you will find the factor of .7513. By Multiplying this factor by the future value amount desired ($100,000 in the example) your result is $75,130. Use of a table is not as precise as the answer a calculator will provide, but it is close enough to provide the information a very close approximation.

Therefore Annuity Tables or a financial calculator can be used to determine amounts needed at a later point in time based on given rates of return known today. In other words, we can easily determine how much money is needed right now for investment in order to achieve some specified future value of money.

All of these Annuity Tables and financial calculators aside, one of the simplest and most useful rule of thumbs is called the "Rule of 72". The rule of 72 allows a person to quickly approximate the amount of time it will take an investment to double in value at a given rate of return (see example #1, below). By the same token, the rule of 72 can also be used to determine the amount of time needed to reduce a sum of the money in half (see example #2, below).

Rule of 72 Examples:

1) AT A 6% RETURN, HOW LONG WILL IT TAKE A GIVEN SUM OF MONEY TO DOUBLE IN VALUE?

$$\frac{72}{6} = 12 \quad \text{(12 YEARS)}$$

2) GIVEN A 10% RATE OF INFLATION, HOW QUICKLY WILL PRICES DOUBLE IN COST?

$$\frac{72}{10} = 7.2 \quad \text{(7.2 YEARS)}$$

3) IF I WANT TO INVEST MY MONEY SO THAT IT DOUBLES IN VALUE IN 5 YEARS, APPROXIMATELY WHAT ANNUAL RATE OF -RETURN MUST I ACHIEVE?

$$\frac{72}{5} = 14.4\% \text{ RATE OF RETURN REQUIRED}$$

Future Value of Annuity and Future Value of Annuity Due.

These two types of problems have many practical applications in today's business and financial world. There are many situations were individuals or corporations will invest sums of money on a periodic basis, wanting to compare alternative returns. A good example, on an individual basis, is an IRA to which $2,000 is added on an annual basis, for example. Determining the future value of the annuity when it becomes due is a very practical consideration. Using the mathematical concept of future value of an annuity or annuity due will help you counsel clients in this area.

The difference between Future Value of Annuity (FVA) and Future Value of Annuity Due (FVAD) is the point at or from which interest compounding occurs. The FVA calculates value and credits deposits based on an end-of-the-year basis, while the FVAD calculates value and credits deposits based on a beginning-of-the-year basis. A sum calculated on an FVAD formula will be greater (larger) than when applying the FVA formula.

Assume $1,000 is deposited at the end of each of 3 years and earn 10% annual interest. What is the total future value using an appropriate value table?

$3,310

Using a appropriate "future value of annuity" table properly would enable the user to find a mathematical factor of 3.3100 for the return of 10% each year for three years on the same sum deposited each year" Multiply 3.3100 by your deposit sum ($1,000) and you have the answer shown above.

Future Value of an Annuity Due

FVAD is used **BECAUSE** each deposit made is being credited on a **"beginning of the year"** instead of the end of the year basis (as is the case with FVA)

Assuming, in our previous example, the $1,000 deposit is made at the start or beginning of each year for 3 years and earns 10% interest, then answer is as follows:

$3,641

Because the interest is paid from the beginning of the period rather than at the end, the total increases, as evidenced above. The use of a financial calculator is a great aid in these applications.

Uneven cash flows.

Unfortunately, calculations such as those mentioned above, are often used for finding amounts that are not equal at the beginning or end of every deposit period. Therefore we have to know how to deal with uneven cash flows (cash flows which are different in amount and are deposited into an account at various points in time). To illustrate this concept present value of uneven cash flows, consider the following example:

Your son will be a college freshman in one year. You estimate his annual tuition needs as follows: Year l $5,000; Year 2, $5,500; Year 3, $6,100; and year 4 $6,800. You can open an account paying 10% interest which will allow you to withdraw money each year as it is needed. What lump, or single, sum of money must be deposited today in order to pay tuition at the points in time as stated above, while leaving a zero balance after the fourth withdrawal is made?

In utilizing a "Present Value of a single sum" table , the problem is easily solved by creating the following table for:

End of Year	Withdrawal Amount	PVSS Factor	PVSS
1	$5,000	.9091	$4,545.50
2	$5,500	.8264	$4,545.20
3	$6,100	.7513	$4,582.93
4	$6,800	.6830	$4,644.40
			$ 18,318.03

$18,318.03 put into an account today, which earns 10% compound interest will provide the needed funds at the proper time with an ending balance of zero after the fourth withdrawal.

Compounding Frequency.

The more often you apply interest to a sum of money, generally the greater the amount will be as opposed to less frequent compounding. Put another way, even at the same rate of interest, an account which is compounded twice a year or semiannually will not become as large as an account which compounds on a monthly or quarterly basis. Although the "effective yields" as they are called, do not result in a huge percentage difference, **the difference in dollar amount can be substantial,** especially with large sums of money. The main rule to remember**: the more frequently compounding occurs the greater the future value becomes.**

When examining the nominal and effective yields on a sum of money, start with an **annual compounding rate. This means the "nominal" and effective annual rates are the same**. As you begin to compound on a more frequent basis than annually, the effective rate increases depending upon the frequency of the compounding. The nominal vs. effective rates at 7%, at selected compounded frequencies, are illustrated below:

7% Nominal		**7% Effective**
7% Annual	=	7.0000%
7% Semi-Annual	=	7.1225%
7% Quarterly	=	7.1859%
7% Monthly	=	7.2290%
7% Weekly	=	7.2458%
7% Daily (365)	=	7.2501%

Present Value and Future Value Sample Problems.

Now it is time to put some of this present and future value knowledge to good use as relates to the practice of marketing life insurance. **We are going to look specifically at two applications**: The first will deal with the effect of inflation on projected life insurance proceeds and the second will examine proceeds plus rates of return, utilizing **principal preservation versus principal liquidation** as a means to supply income in the event of premature death.

First, the effect of inflation on life insurance. A family has decided a $200,000 death benefit would be an adequate amount of money for the family to meet their ongoing living needs for a specified period of time. You, the agent, need to be concerned with updating the plan periodically if want the full purchasing power of this $200,000 is to be retained over time. If we agree on some inflation rate (in this example we will assume annual 5% inflation) being applied which will reduce the purchasing power of these proceeds, then we can recommend updated coverage amounts, at various points in time, which will preserve the original purchasing power of the proceeds selected.

Although it may be impractical or inconvenient to increase the value of one's life insurance by 5% each and every year, certainly we can update every three or, at the most, every five years.

PROBLEM # 1: Assume our clients feel that there will be a 5% inflation rate each and every year for the next 20 years. Furthermore, every 5 years they have agreed to update their insurance coverage in order to retain the purchasing power of an original $200,000 of death benefit. You need to calculate at the end of year 5, at the end of year 10, at the end of year 15 and at the end of year 20, the total amounts of insurance in force which will retain $200,000 of purchasing power, according to today's value. The easiest way to calculate is as follows:

5% annual inflation each year for 20 years. Update Life coverage of $200,000 every 5 years to keep pace with inflation.

If we search for a factor from a table for the “future value of a single sum” (in this case that single sum is 200,000) for an "n" value at 5 years for 5%. we will find the correct factor of 1.2763. We then apply it as follows:

END OF YEAR:	PROCEEDS NEEDED	FACTOR
5	$255,260	(200,000X1.2763)
10	$325,788	(255,260X1.2763)
15	$415,803	(325,788X1.2763)
20	$530,690	(415.803X1.2763)

At the end of twenty years, **$530,000 of life insurance is needed just to keep pace with 5% annual inflation!** In other words, given 5% annual inflation, in 20 years $530,000 will buy no more goods and services as does $200,000 today.

(If we used a financial calculator for this same problem we would enter 20 “n”, 5 “i” and 200,000 for the PV (present value). By then hitting the FV (future value) key, the display will show an answer of $530,659.54 which is a precise and exact answer)

If we used the rule of 72 here we would get the most imprecise Answer of all three methods, but in the ballpark, nonetheless (approximately $510,000, rounded to the nearest ten thousand).

The previous example should clearly demonstrate why updating coverage (life, health, auto and homeowners) is so essential.

Another approach to counseling about the amount of life insurance which is necessary to meet client needs is to find out if they wish to **use some of the proceeds** to actually help fund their living expenses, or whether they **strictly** want to **use interest earnings** from the principal (proceeds).

If they plan on using the principal as well as the interest, in the event of premature death, then a smaller death benefit will be sufficient rather than if the interest alone on the principal amount of the proceeds is going to be used to generate income to meet living expenses. Look at the following example of the principal preservation, or retention method, versus the principal liquidation concept.

EXAMPLE: Joe Smith wants to purchase enough insurance to supply his family with a fixed income of $25,000 per year for 20 years. He asks you to show him how much proceeds he needs to buy for each of the following conditions.

1) The proceeds generate enough interest to supply the $25,000 annual income with an assumed 7% compounded annual rate of return. At the end of 20 years, the entire principal is to be donated to the "Save the Peanut Foundation.”

2) With a 7% compounded annual return, how much proceeds will supply $25,000 of annual income for 20 years so that a zero principal balance exists after the 20th payment is made?

Answers to "Joe Smith" Example

#1) This is quite simple. This is the principal preservation, or retention, concept. If we assume that 7% annual rate of return will generate $25,000 annually without affecting principal, simply divide the desired income by the interest amount:

$$\frac{\$25,000}{.07} = \$357,143 \text{ Life Insurance Needed}$$

#2) This is more complex. We want to liquidate a sum of money in such a manner that $25,000 of annual income is applied for 20 years and then a zero balance exists given a 7% return. This is a Present Value of an Annuity calculation on a beginning-of-the-year basis.

To answer using an appropriate "present value of an annuity" table to find the 20-year factor at 7.0%. we would locate the correct factor of 10.5940.

Then we multiply the desired payment by the factor:

$25,000 X 10.5940 = $264,850

Is this the "FINAL" answer to the question?

No! The above answer, $264,850, is the end-of-the year payout amount and we need the beginning-of-the-year payout amount. **One more step is necessary:**

Multiply $264,850 by (1 + i)

1 + i = i +.07 or 1.07 PVAD (Present Value of an Annuity Due)

264,850 X 1.07 = $283,389.50

Summary of Answers:

1) For capital retention: $357,143

2) For capital liquidation:$283,389.50

As you can see the ability to deal with present and future value tables can make otherwise boring insurance equations come to life because they help meet the actual needs of real individuals and families. **A far simpler way to calculate these numbers is to purchase one of the several fine business calculators that are available.** Knowing which calculator keys to press eliminate all the time otherwise spent looking for factors from the tables.

PART VI: Taking Inventory: The Personal Balance Sheet

Determining Net Worth.

A person's net worth is calculated by use of a simple equation:

ASSETS minus LIABILITIES = NET WORTH

Although this is a fairly simple concept, determining exactly what is an asset and what is a liability is more complicated. **Assets are simply things which are owned by clients**. Things that are not owned but are rented or leased are not assets of the individual or business. Assets can be divided into many categories but the simplest two would be financial assets versus personal assets.

Liabilities, on the other hand, are the debts of the client. Various types of liabilities include short term (liabilities due in one year or less), intermediate (due in one to five years) and long term (due in more than 5 years). Properly calculating liabilities often results in estimating bills which are not yet received, but are due.

Assets minus liabilities results in number which represents a person's net worth. This is a measure of a client's equity value, or wealth, at the point or date of the financial statement calculation. If a client were to sell off, or liquidate all assets at fair market value and subsequently pay all debts, the dollars left represent net worth.

Five Basic Consumer Levels

We can categorize the wealth of individuals at many levels. To keep it simple we will restrict this study to five basic groups of consumers. **The difference between each group of consumers is income level and net worth.** This helps determine the types of financial products and services which will be sought in the marketplace.

1) The Very Wealthy - this is highest group and includes people who have **net worth in excess of $1,000,000 and income exceeding a half a million dollars a year**. A very tiny percentage of all Americans belong to this elite club. This group consists of people who have inherited large sums of money, own their own businesses or are chief executives in large corporations. This group will turn to comprehensive, financial and estate planning in order to minimize taxation and

maximize the preservation of wealth at the point of death. **This group will seek the services of individual financial planners and experts who can bring together a team to best suit their complex needs.**

2) Upper Income Level - In this group would be small business owners, people in upper management and highly successful professionals (doctors, lawyers, etc**.). Net worth would be less than 1 million but in excess of $500,000 and income level would generally be somewhere around $250,000**. While the needs of this group are very great compared to others, they are not as great as the very wealthy group. Individual financial planners would still be sought to a large extent, but mainstream would participate in some specialized investment program, goal setting and implementation. **This group can afford, and is very likely, to enlist the services of large planning firms.**

(3) Middle Income Level - This is a high income white collar market, with **income somewhere around the $100,000 a year level and net worth of about $250,000**. This group will also include small business owners and middle to upper management types in a large corporate work place. This group will rely more on larger financial planning firms, financial supermarkets, banks and insurance companies to help them engage in beneficial financial planning. Goal setting and individual counseling is very important here, as well as in the upper income level group (group #2, above).

4) White Collar/ Two Income Families - Two income families who earn approximately $50,000 total household income per year and have a net worth close to $100,000 would also primarily turn to banks, insurance companies, and firms marketing securities on a national basis. Prepackaged, computerized plans will be available to these people and their main needs will be satisfied by such products as life insurance programs, money market funds and mutual funds.

5) Blue collar markets - a one, maybe two, worker family with income not exceeding $25,000 a year and very little or no net worth. This group is the marginal (little) or no savings group. The main products or financial products or services which they will purchase will include life insurance, IRA's, money market funds, and band CD'S. They will not engage the use of, or employ, personal planning services professionals.

If it seems the more money you have is directly related to the opportunities which exist, plus the more help you can receive in managing that money, you are right! . The idea that money begets money is an ancient concept still very much in evidence today.

VII) Financial Planning Services: The Next Profession?

Defining a profession - Defining what is a profession vs. what is not a profession is not a simple, clearly defined, matter. There are many single attributes which can be identified, some of which belong to a profession and some that do not. It is when we take many characteristics and look at them as an entire set that the professional definition becomes somewhat clear. Some basic characteristics are as follows:

1) The public perception or recognition that a profession exists (i.e. doctors, lawyers)
2) A commitment to high ethical standards
3) An attitude of altruism, or being of service to others
4) Educational preparation and training, which is mandatory and state and/or federally sponsored.
5) Continuing education which is mandatory
6) The establishment of a formal association to which members belong
7) Independence from the influence of other professionals.

Individuals who meet these basic qualifications as part of an overall group are generally identified as possessing professional status.

The Profile of a Professional- What about the individual who considers what he or she does, on a daily basis, to be a profession?

Perhaps the actual activity in which they engage is not considered, as a group, an accepted profession. But there is no denying that some individuals perform at such a high level of commitment and dedication, that no other word will fit or describe their activities. Although others in the same group may not push themselves to the such high standards, or degrees of learning as do these individuals, some people always perform a cut above the rest. This discussion brings up the concept of the group versus the individual in the arena of professionals.

Is professional status only to be given to all members of a severely limited number of occupations, or can a professional be a very limit number of people in a large range of occupations? The debate can be heated, but it is clear that for those few people in varying occupations who exhibit a high degree of professionalism and commitment, no other word but professional will define their activities.

Professional commitment - In addition to meeting certain basic requirements to enter a given occupation (i.e. passing some sort of standardized exam or achieving a certain degree of education) many other factors must be considered.

Underlying the entire concept has to be the drive or desire of the individual. This desire is heightened by actual day to day service to others and, in the long term, the commitment to continuing mandatory education. An individual in any occupation who does not keep current with the times and issues surrounding them and their service can never hope to be called a professional. Professional status is reserved for those who are constantly learning and updating their knowledge in order to serve the consuming public to the highest level and to the best of their ability.

EPILOGUE

Is financial planning the next great profession? Obviously the financial planning needs of a large segment of the American public are becoming more and more clear every day. As people scurry about and engage in their own professions furthering their own occupations, the professional management of their money looms as a larger and larger consideration.

A profession that can serve these needs on a trustworthy and professional basis definitely appears to be a necessity. However, until some standardized format is established and followed, can the "financial planner" ever be a true professional. Standards vary from program to program (CFP, CHfC, CLU, ETC.) and the commitment to continuing education is not, as yet, universally recognized or required.

Until the public perceives the financial planner in a light where the consumer's needs are being served first and foremost always, it is doubtful that the "financial planner" will ever achieve true professional status.