Life Insurance Planning

Life insurance is most commonly used to protect against the risk of economic loss due to the premature death of the insured. It is increasingly used to preserve estates by providing funds necessary to pay estate taxes and settlement costs, or to restore the value of assets lost to these wealth-transfer costs.

Legally, life insurance is a written contract between the policyowner and the insurance company. To be a valid contract, the policy must exhibit risk-shifting, and must meet the Internal Revenue Code definition of life insurance (IRC Section 7702).

Life insurance proceeds are usually free from income taxes and premiums are generally not income-tax deductible (exceptions include employer-sponsored Group life insurance, employer plans sanctioned under IRC Section 162(a), and certain arrangements qualifying as charitable donations). Under current tax law, cash value increases of life insurance policies escape current income taxation, cash withdrawals may ordinarily be taken on a favorable FIFO basis, and loans can be made free from income taxes so long as the policy eventually matures as a death claim.

An economic view of life insurance should take into account both its risk-management value and its investment potential.

Life insurance may be used to:
- Create an estate: where time or events have prevented the insured from accumulating sufficient assets to care for dependents, life insurance provides cash to support survivors
- Pay off mortgages and loans, both personal and business
- Provide cash for special needs, such as a child's education, or support for a disabled dependent
- Pay death taxes and other wealth-transfer costs. Life insurance can provide funds outside the taxable estate to pay settlement costs, or can replace estate assets used to pay these costs
- Equalize inheritances: if the family business passes to only those children active in the business, life insurance can provide other children with an equal inheritance
- Finance a business transfer
- Indemnify a business for the loss of a key employee
- Fund benefit programs for employees
- Provide direct bequests to charities or replace assets left to charity, so that charity does not benefit at heirs' expense

Among the advantages of life insurance are:
- A significant amount of cash is payable following death of insured
- Proceeds are not part of probate estate, unless they are paid to the estate of the insured
- Proceeds are protected against creditors of both the insured & beneficiary
- Cash values of personally-owned life insurance are protected against creditors of the insured
- There is no public record of amount of proceeds nor beneficiary
- Proceeds are generally not income taxable
- Proceeds can be arranged to escape death taxes
- Cash value growth of permanent insurance is tax-sheltered, and access to cash values is generally tax-favored

Disadvantages include:
- The insured must qualify medically and financially for coverage
- Premium expense reduces cash available for current consumption or other investments

Types of Policies - Two Broad Categories

Life insurance is a complex product; analysis and cost evaluation may frustrate buyers, particularly if they are comparison shoppers.

Term Life Insurance provides pure protection for a definite, often limited, period of time.

During the pure protection (term) period, the policy is a risk-management tool, analogous to auto or homeowner's coverage. However, unlike property insurance, most term policies may be renewed at the policyowner's option, albeit at a high premium cost.

For many years, annually increasing premium term coverage provided the lowest cost to the buyer. However, in recent years, policies with level premium periods (10, 15, 20 or even 30 years) have dominated the market. Rule of thumb: the low level premium of a term policy generally ends before the normal life expectancy of the insured (e.g., most carriers do not issue a 20-year guaranteed level premium term policy beyond insuring age 60). Most term life insurance is issued on a single life, but a few carriers offer joint-life policies. A joint second-to-die policy pays proceeds at last death; a joint first-to-die policy pays proceeds at first death.

The primary disadvantage of term insurance is that the low-cost period of the policy may expire before the need for the coverage ends, and the insured's health may preclude his or her buying a new, low-cost term policy.

For example:
A healthy, non-smoking male age 45 buys $1,000,000 of 20-year level premium term. For 20 years, the premium is $1,700. In the 21st year, at age 65, the premium will increase to $33,430. If he is still healthy at age 65, this insured may be able to buy a new 15-year level term policy for a premium of $8,800 (20 year level premium would not generally be available at his attained age) and continue coverage to age 80 at a relatively affordable cost. However, if he is not healthy and cannot replace the original policy, his premium will continue to escalate. By age 75, the annual premium will be $61,000. By age 81, he would have paid in over $1,000,000 in total premiums for the protection.

Cash Value Life Insurance allows the policyholder to schedule coverage which provides protection for as long as the insurance is needed, at a reasonable cost.

Prior to 1980, cash value life insurance was commonly a whole life policy with a fixed, guaranteed and usually level premium, a guaranteed death benefit and a schedule of guaranteed cash values. The whole life policy was designed to provide lifelong protection, and is properly termed permanent life insurance. It is unusual to find a whole life policy today that does not pass through at least some of the carrier's experience to the policyholder. This can be in the form of a dividend, in which case the policy is called participating,@ or may be in the form of credits made directly to the cash value of the contract.
The advent of Universal life in the late 1970's introduced a new form of cash value life insurance, with flexible premium, flexible death benefit, and fluctuating cash values.

Although Universal life evolved later than whole life, it is perhaps the easier of the two policies to understand. The policyowner pays a premium in an amount and frequency of his or her selection; there are minimum and maximum premium requirements, but within those limits, the policyowner has great latitude. The premiums, less loads, are put into an accumulation account. Each month, the insurance carrier deducts from the account the costs of insurance, which are the term insurance costs at attained age of the net amount at risk (the difference between the total promised death benefit and the cash accumulation account) plus charges to cover administration and other expenses. The carrier also credits monthly interest to the account, determined by a declared rate of interest. The carrier's monthly deductions and monthly interest credits are based upon current experience; there are contractually-guaranteed maximum charges and minimum interest schedules, but these are generally less favorable than a carrier's current experience.

The policyowner's objective is to keep enough cash in the accumulation account to cover the monthly deductions. Typically, he or she will schedule or target a premium based upon assumptions about the carrier's crediting rates and costs of insurance, the number of years the premium should be paid, the number of years the policy should remain in effect, and cash value objectives, if any, for the policy. Since the assumptions made about interest rates and costs of insurance may not be realized, it is very important that the policy's actual performance be monitored periodically to make sure that it remains on target to provide the necessary coverage for the desired period of time.

The whole life policy, particularly the participating policy, is not as transparent in its workings as the Universal contract, but it can be understood as a Universal life policy with premium determined by the minimum interest the carrier will credit and the maximum charges it can deduct. Those contractual minimums and maximums combine to produce a premium (generally level to the insured's age 100) which will by definition support all required costs of insurance to the insured's age 100, and in addition to covering those expenses, will accumulate a cash value equal to the initial death benefit of the policy.

We've already noted that the whole life guarantees are less favorable than the carrier's current experience, and in participating whole life, part of the carrier's surplus is returned to the policyowner in the form of a dividend. The most

common use of the dividend is to offset premiums; typically the policyowner pays the premium each year until dividends accrued and dividends anticipated are used to offset premiums as they fall due. Since dividends are based on the carrier's actual experience, they are never guaranteed.

The cash values of most life insurance policies are supported by the general account, or a subset of the general account, of the issuing carrier. The carrier's investment acumen has a direct impact on the amount of interest credit or dividend it is able to pay. Also important is the carrier's underwriting expertise, since claims experience directly affects the mortality deductions of Universal and the dividend credits of whole life. Other experience factors, such as administrative expenses, magnitude of policy loans and withdrawals, and policy persistency also play a part in policy performance, but are generally less critical factors than earnings and claims experience.

Over the past two decades, Variable life and Variable Universal life policies have risen in popularity. The basic product design mimics that of whole life and Universal life, respectively; however, the Variable policies permit the policyholder to allocate a portion of each premium payment to an array of investment options, called separate accounts. As more carriers and products have entered this market, the investment choices made available have increased significantly; many policies offer 20 or more account options, and carriers employ fund managers whose names are readily recognized by mutual fund investors. An additional advantage of Variable products lies in the fact that in most cases cash values invested in the separate accounts are not subject to the claims of the insurance carrier's creditors; if the carrier becomes insolvent, cash values are protected.

Because the investment options available inside a variable policy include securities, Variable life insurance policies are registered products, and the SEC requires presentations of the policies to be accompanied by a prospectus.

Cash value life insurance - whether general account or Variable - can insure a single life or two lives jointly. Survivorship or second-to-die insurance insures two lives, and pays the death proceeds upon second death. First-to-die policies insure two lives, paying the proceeds upon first death. Some carriers issue first-to-die policies insuring more than two lives; two insureds are covered under cash value insurance, and additional lives are insured using term riders attached to the basic policy.

All forms of life insurance are basically actuarially equivalent. Although after-the-fact costs may vary for a particular insured life, on aggregate, an insurance carrier prices products so that each policy type's expected premium provides adequate funds to cover its expected death proceeds and expense costs (plus add to the carrier's profits). For example, the annual premium of a second-to-die contract insuring a husband and wife age 50 is roughly 60% of the cost of insuring the wife only for the same face amount. This is because the life expectancy of a single individual is actuarially shorter than joint-life expectancy.

Selecting The "Right" Policy

Selecting an appropriate policy has four facets:
- Selecting a good insurance carrier
- Selecting the correct type of insurance for the need
- Deciphering life insurance policy illustrations
- Applying policy comparison measurements

Recommended Carrier Selection Criteria

The financial strength of the insurance carrier is an important consideration in selecting a company from which to buy any form of insurance. Because of the long-term nature of most cash value life insurance policies, selection of the carrier issuing this form of insurance is critical.

A financially-strong carrier is able to meet its contractual benefit obligations and is an excellent position to provide non-guaranteed performance enhancements such as dividends and excess interest credits. Although no financial-strength evaluation is infallible, and future performance is impossible to predict, current evaluations by professional ratings analysts should be carefully considered. Ratings services such as A. M. Best Company; Standard and Poors Insurance Rating Services; Moody's Investors Service; Fitch IBCA,; and Weiss Research are all recognized specialists in the evaluation of carriers. It is generally recommended that the buyer consult several ratings services and select carriers with ratings in the excellent categories of at least three analysts.

Additional criteria may be important if there are particular underwriting considerations, or if the amount of insurance needed is very large. Amounts of insurance in excess of $20,000,000 may be beyond the capability of a smaller carrier; special health, residence and travel, or vocational risks may require a company which specializes in these risks.

Matching the Policy to the Problem

Among the considerations are:

- Amount of insurance needed
- Duration of the need
- Cash flow constraints
- Preferences and priorities of the buyer: risk-taking propensity, overall investment goals, and personal biases all enter into the selection of the product

Income replacement, debt retirement, key employee insurance, and buy-sell funding are all needs that are typically satisfied with term insurance, or some combination of term and cash value life insurance.

Buyers with discretionary dollars - particularly buyers aged 45 to 55 - may see the efficacy of the tax-sheltered build-up of cash values and creditor protection afforded by cash value life insurance, or may find the investment element of the Variable policy attractive.

Insurance to provide estate liquidity will generally be cash value life insurance which provides a death benefit regardless of when the insured(s) may die. By far, the most commonly-purchased insurance in this market is second-to-die (survivorship) coverage.

Evaluating Policy Illustrations

Policy illustrations are used in the buying process for all forms of life insurance. However, they are most important - and most subject to misinterpretation – when the buyer is considering cash value life insurance.

Cash value life insurance policies include guaranteed costs and benefits which are outlined in the contract between the insurance company and the policyowner. A policy illustration must show these guaranteed aspects and may also exhibit potential costs or benefits which are beyond the guaranteed values. It is the non-guaranteed elements which make today's cash value life insurance policy an attractive product, and it is important that these elements be illustrated responsibly by the insurance carrier.

Beginning in January, 1997, states began to adopt the guidelines proposed by the National Association of Insurance Commissioners in its Model Illustration Regulation. The Regulation attempts to standardize some aspects of insurance illustrations so that consumers can more completely understand the product they are buying, be more fully informed about the long-term effects of adverse insurance carrier experience in earnings and mortality, and more readily compare products. Importantly, the Regulations provide that illustrations shown at non-guaranteed current assumptions must be supportable by the carrier's actual current experience.

The guidelines attempt to eliminate the use of speculative assumptions of non-guaranteed performance, such as future improvements in mortality or expenses, and to show the buyer the impact a change in the non-guaranteed factors might have on future performance. Most insurance carriers have adopted the Regulation's standards nationwide, even though it is not currently law in all jurisdictions.

The NAIC Model Regulation eliminates the differences in illustration formats among carriers, and sets rules of reasonableness, but does not totally eliminate differences in the way non-guaranteed elements are determined. For example, insurance companies may use different methods of setting current interest crediting rates for Universal life policies. Some use a portfolio rate supported by actual yield on all or a specific portion of the company's assets, others use an investment generation method which tracks the yield earned on investments made during a certain time period, and still others use a blend of the two methods.

Illustrations can serve as general indicators of what policy costs and benefits will be under a certain set of assumptions. However, illustrations cannot forecast the future, and actual results over the years the policy is in force will almost certainly be different from the original illustration. Illustrations are useful tools in understanding how different types of policies function, but may not be fully reliable in comparing policies or in selecting one carrier's products over those of another.

Comparing Policies

For many buyers, comparing term insurance options is often simply a matter of comparing premiums (including the duration of the premium guarantees) among policies offered by carriers of similar financial strength, because the need for insurance is of short duration and premium is the overriding consideration. Other buyers may have additional concerns, including renewal rights and conversion options, but typically a term purchase is a cost decision. The term market is dominated by a relatively small number of carriers specializing in the product, and the product features and cost differences among products offered by these carriers is relatively small.

Comparing different varieties of cash value policies may be inappropriate, and in some cases, illegal. Compliance regulations relating to Variable products specifically prohibit direct comparison of these Registered products to general-account policies.

Even where allowed, cost comparison across policy forms is difficult, and may fail to recognize policy features which contribute value to the contract. For example, the illustrated cost of a basic whole life policy with a large amount of term rider may be lower than the illustrated cost of a Universal life policy. However, the Universal life policy has considerable premium flexibility and ease of access to cash values that are typically lacking in the whole life policy. Comparing only the premium does not take into account these additional features.

Major insurance carriers are under pressure to maintain strong financial positions while offering the most competitive products available. Generally speaking, if a buyer obtains current assumption illustrations of whole life policies from half a dozen carriers of similar size and with similar analysts' ratings, there would be relatively minor differences in illustrated premium and non-guaranteed performance. A buyer should be suspect of any policy illustration which shows performance substantially better than its competition; if the marketer or carrier cannot provide reasons for the better performance, caveat emptor.

Determining the Amount of Life Insurance Needed

From a pure risk-management standpoint, if a person could be sure he or she would live longer than average, the best deal would likely be something other than life insurance. Most people recognize the impossibility of such predictions, and buy some amount and some form of life insurance.

Income Replacement Approach – Human Life Value

One method used to estimate life insurance needs is based on the concept of human life value. Human life value has often been applied in wrongful death litigation and in its simplest form, holds that the measure of the economic value of a life is the present value of his or her future earnings.

The concept of human life value as the basis for determining life insurance needs was popularized by Solomon Huebner in a doctoral dissertation in 1927 and later in a widely-read book. Using this approach, the amount of the insurance needed is the lump-sum payment which will replace some or all of the earnings lost should an income-producing family member die.

Human life value is easier to understand than it is to calculate, because a person's economic worth depends upon a number of factors, including

- current earnings (salary, bonus, commission, employer-provided benefits such as health insurance premiums and pension or 401(k) contributions)
- projected rate of growth of earnings throughout working life
- future working lifetime
- amount of taxes which will be incurred
- a reasonable discount rate

Additionally, the calculation will involve deducting some portion of the insured's income as an amount needed for self-maintenance, and thus not spent in support of the family. The final step to arrive at an appropriate amount of life insurance is to deduct any existing life insurance, Social Security survivor benefits, and any assets available to fund the survivor's income needs. Proponents of this approach to insurance needs analysis theorize that Americans as a group are severely underinsured. In 1997, Litigation Analytics, Inc.'s publication, The Verdict, estimated the total human life value in the United States as $45 trillion. In comparison, the amount of ordinary life insurance (non-Group, non-industrial coverage) was estimated at roughly $11 trillion.

Needs Analysis

In contrast with the human life value approach, which is founded on the premise that the insurance need should be based on the income that would be lost if the insured died, the needs-analysis approach estimates the insurance amount by directly examining the family's total cash needs. Generally, the analysis separates needs into two categories:

- Lump sum needs at death, including final expenses, estate settlement costs, debt liquidation, tax liabilities, education funds, emergency funds, special needs
- Multi-period income needs, including provision for additional income during an adjustment period, surviving spouse's income needs, children's income needs, spouse's retirement needs

Income needs may be satisfied from various sources, including Social Security benefits, spouse's earnings, annuity payments, employer-sponsored survivor and pension benefits, and investment income. Income needs in excess of existing sources are provided by a lump-sum investment of insurance proceeds.

To quantify the lump sum needed for survivors, the buyer must determine a reasonable investment rate for the insurance proceeds, make allowance for taxation of investment earnings, factor in some level of inflation for the needs of the survivors, and decide whether to conserve or deplete capital. If capital is to be depleted, then the duration of the need must be determined, which generally means estimating the life expectancy of the survivor(s).

Financial Underwriting Guidelines

No matter how complex the calculations, the amount of insurance applied for will probably not be issued if it exceeds the insurance carrier's estimation of the need. Most carriers will make adjustments to their guidelines if the applicant and his or her advisers can make a strong argument for additional coverage, but large deviations from guidelines are uncommon. Here are underwriting standards for a carrier whose target market is executives, professionals and high net-worth individuals:

Personal Insurance Needs

Total personal needs will be a combination of the two following needs, minus any personal life insurance coverage already in force.

Survivor Needs ' Earned Income x Factor (Earned income includes salary, bonuses, commissions, deferred compensation, and company benefits such as pension or 401(k) matching contributions). Factors:

Ages 20 - 24	20	Ages 50 - 54	11
Ages 25 - 29	18	Ages 55 - 59	10
Ages 30 - 34	16	Ages 60 - 64	8
Ages 35 - 39	14	Ages 65 - 69	6
Ages 40 - 44	13	Ages 70 - 74	5
Ages 45 - 49	12	Ages 75 +	4

Estate Settlement Costs ' Tax Liability + Administration Costs.

Ages 0 to 49	may inflate estate needs at	4% for 15 years
	or	6% for 12 years
	or	8% for 10 years
Ages 50 - 65	may inflate estate needs at	4% for 12 years
	or	6% for 10 years
	or	8% for 5 years
Ages 66+	current needs only; no projections allowed	

Business Insurance Needs

Key Person indemnity insurance purchased by a business is generally limited in amount to a multiple of earned income, with some adjustment for size of company, whether the proposed insured has an ownership interest in company, actual duties performed, and the nature and financial position of the business.

Under age 35 10 | Ages 35 - 60 5 - 10 | Ages 60 + 1 - 3

Buy/Sell and Stock Repurchase insurance amounts are determined by the insured's ownership percentage and fair market value of the company. Generally, very little allowance is made for company growth potential.

Creditor or Business Loan Coverage is generally capped at 75% of the loan. The amount of insurance may be less depending upon amount and purpose of loan, duration of loan, collateral pledged, and interest rate; the loan must be for a term of 5 years or more, and coverage will be issued on key individuals only.

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