Table of Contents

I. Retirement and Other Insurance Concepts

A. Third Party Ownership Is allowed as long as there is insurable interest at the time of application. A parent may own a policy on their children, spouses on each other, while business coverages will be 3rd party ownership. The owner maintains all the owners' rights in most situations. The only time they do not is in a group policy, and this is regarding the beneficiary. A plan for the employees is owned by the employer, but the employee may choose the beneficiaries and generally they cannot be the employer.

B. Viatical Settlements are simply a term used when a policy is sold to a third party for cash. A policy with cash value could be surrendered, but the viatical settlement company could pay more than the available cash value. 50% - 80% of the death benefit can be paid with the company taking ownership of the policy, becoming the new beneficiary, paying the premium, and profiting when the insured dies. Persons who are terminally ill will be the client, generally less than 2 years life expectancy, although some companies offer the plan to those who will live longer than 2 years. These are not STOLIs since the client had the policy for a purpose other than selling it and they were not approached by a third party to purchase it to sell.

- Accelerated Death Benefits in the policy can pay 80 or 90% of the face value to the insured without tax consequences and could make this unnecessary. The beneficiaries would then have a small payout.

C. Life Settlements are different than settlement options. Similar to a viatical the main difference is in the life expectancy of the insured. This could be up to 15 years. Used often by seniors who no longer needed insurance coverage and the plan could pay out more than the current cash value. It averages 20% of the face value of the contract as a payout.

The advantages for both would be immediate cash to be used for whatever the clients wants. From alternative treatment to a family reunion, personally distributing cash to the beneficiaries while still alive, it is up to the client. No more premium payments due is another budget plus.

Disadvantages include nothing left for a beneficiary, exposure of the amount to creditors that would not be exposed as a death benefit, or impact on eligibility for aid from other sources, e.g., Medicaid. The death benefit tax advantage may be lost as well.

D. Group Life Insurance differs from individual life insurance contracts in many areas, including underwriting and some policy provisions. It is life insurance though, and will pay a death benefit as long as premiums are paid. The majority of group life is employer-sponsored, but almost any group is eligible.

- Group life coverage is concerned with the selection of risks by group factors rather than by individuals.
- **A group of individuals may NOT have come together for the specific purpose of securing group insurance protection.** Insureds may also purchase coverage for a spouse and children through this plan.

- Group life insurance can be issued to trustee groups, debtor groups, credit union groups, labor union groups, insurance producer groups, State Patrol Association, and financial institutions.
- Employee Group is where a single employer gets coverage for its employees. Employee groups (the most common) now account for almost 90% of all group life coverage in force.
- The Employment Probationary Period (not more than 90 days) is nothing more than a period of time established by the employer for all new employees before the employee will be eligible for any group benefits. This is to avoid adverse selection by the carriers.
- Master Policy vs. Certificate of Insurance… The employer/sponsor owns the policy and receives the master policy; enrollees receive certificates of insurance. The insurer will issue to every insured an individual certificate regarding insurance protection, benefits, and rights. The certificate must summarize the essential coverage features of the policy and to whom benefits are payable.
- Term Life Insurance… Almost all group life insurance is annual renewable term insurance. Premiums may fluctuate from year to year, depending on the number of employees and the average age of the group.
- The beneficiary may NOT be the employer or sponsor. The only exception to this is Credit Life. A bank is the policyholder and is the beneficiary if the debtor dies.
- Group underwriting is usually written on a non-medical basis, meaning that no proof of insurability is required by the enrollees. **This is only when joining the group though**. *If a person waits to buy into the plan (in a contributory plan) at open enrollment, they may need medical underwriting and could be turned down.*

1. Participation Requirement…what percentage of the group needs to be involved in the plan?

- A ***contributory*** group is where the group member or employee contributes some or all of the premium. With this type of group, the insurance company requires that at least ***75%*** of eligible employees and their dependents be enrolled in the group plan.
- A ***noncontributory*** group is where the employer pays all the premiums. With this type of group, the insurance company requires that ***100%*** of eligible employees and their dependents be enrolled in the plan.
- It is possible to have both plans at the same time. The boss covers the first $50,000 for everyone, but that is not enough coverage to meet everyone's needs so employees can purchase more through the participating plan. As long as the coverage is purchased immediately, there are no medical underwriting requirements. If an employee waits until open enrollment to add coverage, they may need to provide proof of insurability.
- Open enrollment is when all employees can change their plans for life insurance, health insurance, etc. Usually in November for the plan dates of the next calendar year.

2. Conversion Rights for employees and dependents **guarantees** that coverage can be continued (at the insured's option) should the insured leave the group. The insured has **31 days** to convert to a ***permanent and individual insurance policy***. Premium is based on the person's current or attained age with ***no evidence of insurability required***.

- These rights apply for all dependents.
- Conversion rights are also available to all insureds if the employer/sponsor or the insurance company terminates the master contract.

E. Retirement Plans

1. Qualified Plans are savings plans that have tax advantages with the intent to have the individual save money for retirement. Qualified plans are offered by employers, must meet criteria set forth by the IRS, and are held to strict requirements according to ERISA (Employee Retirement Income Security Act).

A plan may be defined contribution or defined benefit:

- ❖ In a defined contribution plan (e.g., 401k), the individual knows how much is going in, but not how much will be there at retirement.
- ❖ In a defined benefit plan the individual does not know what is going in, but knows what will be paid out (e.g., pension). We will focus on the defined contribution plans here.
- All employees who are eligible must be allowed to participate in the plan, minimum participation requirements must be in place.
- All employees must be informed of the plan.
- The plan must be nondiscriminatory regarding matching contributions, meaning everyone gets the same coverage (e.g., 50% match up to $2000).
- All participants in the plan have the same plan limits.
- Satisfy specific vesting requirements.
  - The employee's contribution always belongs to the employee.
  - Vesting means, after a period of time, the amount the company puts in the employee's account belongs to the employee. Initially, the money is still owned by the employer, and gradually ownership transfers to the employee. With a 5-year vesting plan after the first year, the employee owns all their funds and 20% of what the employer has contributed, after 2 years they own 40% of the employer's contribution, and so on. This is to encourage employees to stay with a business for a length of time.
- There is an early withdrawal federal tax penalty of 10% of the taxable amount if the person is not 59 ½ in that year (in addition to the regular taxes on the income).
- There is a late withdrawal federal tax penalty of 50% of the estimated taxable amount if the individual does not start withdrawing funds by a certain age, currently 73.

Benefits of the plans are:

- Contributions are tax-deductible to both the employers and employees.
- Interest earned is tax-deferred until withdrawal.
- Plan types include 401k, 403b (the 401k of the charitable organization employer), Simple IRAs, SEP IRAs, SARSEPs, and profit-sharing plans for employers.
- Self-employed persons can set up a Keogh, HR10 plan, or an individual 401k.

2. Non-Qualified Plans for employers do not meet the requirements of ERISA and do not have the tax advantages. They can discriminate, meaning they could be offered only to top executives or other highly compensated employees. These plans include deferred compensation and executive bonus plans.

IRAs: Technically, since qualified plans are employer-sponsored, an IRA or Individual Retirement Account, whether it is traditional or Roth, is not a qualified plan. A traditional IRA shares many of the limits of a qualified plan: limits on deposits, you must leave the funds in the plan until age 59 ½ or pay a penalty, and you must take distributions by age 73 or a tax penalty is imposed.

- A traditional IRA is generally, though not always, tax deductible.
- The growth is always tax-deferred, meaning it will be taxed on withdrawal. Anyone with earned income can put money into the traditional IRA.
- A Roth IRA is not tax-deductible, but the growth is tax-free as long as the account has been established for 5 years. This means there are no taxes on the money taken out of the plan.
- There are income limits to qualify for a Roth IRA and the funding, as with a traditional IRA, must be from earned income.
- Both have the same annual limit (in 2023 - $6500).
- A traditional IRA has a late withdrawal penalty if the funds have not started a distribution by age 73, a Roth IRA has no such requirement.

F. Life Insurance Need Analysis/Suitability

1. Personal Insurance Needs

Most purchasers of life insurance are looking to take care of a family. Survivor Protection can be taken care of in a few different ways. A lump sum may be paid out, a payment plan may offer consistent income for the beneficiary, or a combination of both options.

Estate creation is the chief function of life insurance. When an insured dies, a definite sum of money will be paid to the beneficiary. The money can be used to meet current obligations of the survivors such as funeral costs and medical bills; pay debts; pay for future expenses such as college education; pay in a settlement option or payout plan to take care of any dependents with physical or mental limitations; serve as continuing income for the spouse; etc. ***It is protection for the consumer***.

a) Cash Needs are used to satisfy specific purposes. Some of these sums are intended to be used at the time the income earner dies, while others are set aside for future use. For example:

- Final Expenses including burial, funeral, last medical expenses, estate administration costs & taxes.
- Pay off debts such as home and car mortgages.
- Education and Emergency Fund.

b) Liquidity — Income Needs are expressed in periodic amounts, usually a monthly figure. This monthly amount is intended to meet all the family's regular living expenses. For example:

- Essentials such as food, clothing, gas, taxes, etc.
- Lifestyle income such as holiday celebrations, vacations, sports equipment, etc.
- Surviving spouse's immediate income and retirement income.
- Even if the mortgage is paid, there are still monthly bills, gas, electric, etc.

A settlement option with a monthly payout plan can do this, or an individual may elect to monitor it themselves.

c) Estate conservation is another valuable tool in the producer's bag. A client may be self-insured, meaning they don't need to create an estate since they have one, debts are paid, and the family is cared for financially. This should not be a problem, but if the estate (everything you own minus everything you owe) is large, there are taxes. Federal and State estate taxes can diminish an estate by a large percentage. A family-owned business (dairy farm, winery, etc.) may need to be sold to pay the tax debt if there are no liquid assets available. Life insurance in the proper amount will keep the business intact and the taxes will be satisfied. It is important here to name a beneficiary since, if the money is left to the estate, it could be counted as an asset and taxed accordingly.

d) Determining Amount of Personal Life Insurance. How much life insurance a person needs varies depending on what they need covered. There are 2 distinct approaches on how to get the magic number and both have advantages and disadvantages. The needs and life of an individual change over time and this may result in an adjustment in the face value of a policy. Basing an amount on what someone earns sounds fine until you consider a stay-at-home parent. They may not have an income, but they contribute enormously to the family unit. Their value cannot be easily measured, so the first approach may not work, but the second one will. We are mainly looking at creating an estate.

i) Human Life Value Approach: This is the financial amount that you would expect a person to earn during the remainder of their working lifetime, a.k.a. the income replacement approach. This is for creating an estate to care for dependents, not preserving an estate nor any other reason to purchase the coverage. It is not just a multiple of someone's current salary; inflation and cost-of-living increases should be factored in as well as career potential for advancement. With young professionals such as lawyers or medical professionals, the projected income would outpace inflation.

ii) Needs Approach: This looks at what the needs of the surviving dependents over time may be. It should take care of immediate expenses such as funeral costs, medical bills, estate taxes., and any other lump sum needs. The needs approach also looks at the long-term needs that differ over periods of time. There will be an adjustment period that should be covered with an income, but then what? If the mortgage is paid, there are still utilities, phone, cable, etc. Is income needed to replace the insured's income 100% or is 75% sufficient? Is there any additional debt to be taken care of, fund education, or an emergency fund? How long should this income last?

In both cases, when a number is reached and agreed upon, look at the assets the client currently has. The amount agreed on for coverage less the amount of existing assets is the amount of life insurance needed.

Regarding estate preservation; an attorney or CPA may suggest an amount needed to pay the estate taxes.

2. Business Uses of Life Insurance can be varied. Businesses need to protect their assets. The most important assets a business has are the people, whether they are the owners or key persons. Protecting them as a benefit for themselves includes funding for various compensation arrangements such as split-dollar arrangements and non-qualified deferred compensation plans. To protect the business itself (employees, customers, partners) we have key employee or partner plans, and buy-sell agreements. The differences between the 2 policies are that, in a buy/sell arrangement, the policy must be on an owner and covered in an amount sufficient to buy out their share of the business. A key person policy may be on the owner, but it can also be on any employee who is considered key to the business.

a) Key Person /Partner Insurance is purchased on the lives of a company's key employees to protect itself against their death. A key employee is anyone who is key to the running of a business and can include the owners. While it may be true that no one is irreplaceable, it can take time and effort, and this can cause financial hardship to the business. An easy example of a key person is a chef at a restaurant. If the chef were to die suddenly, the restaurant needs a new chef recruited and hired. In a key employee policy, the ***proceeds are paid to the business*** to offset a drop in profits and help pay to recruit and train a suitable replacement.

The insured is an individual and must prove insurability.
The business is all of the following:

- **the applicant,**
- **the owner (3rd party owner),**
- **the beneficiary, and the payor of the premiums for the insured (key person/employee).**

b) Buy/Sell Agreements spell out the terms of the sale of an owner's business interest upon his death. The buy/sell agreement is drawn up by an attorney or may be part of the articles of incorporation of a business. **The agreement includes a provision for funding with life insurance**. This assures that the money will be available to pay off the deceased partner's family, and the business will be owned solely by the surviving partner(s). There are two types of Buy/Sell Agreements: Cross Purchase and Entity Purchase.

i) Under a Cross-Purchase Buy-Sell Plan, each partner owns, is the beneficiary of, and pays for the premiums for life insurance on the other partner or partners in an amount approximately equal to their share of the business. Death benefits are received federal income tax-free by the partners and avoid taxation to the company. In a 2-person partnership, this works well. Any more owners will increase exponentially the number of policies required. *(E.g., six partners, each one owns policies on each of the other five, creating 30 policies written.)*

ii) Under an Entity Buy-Sell Plan, or a **Redemption Plan**, the deceased's interest is purchased from the deceased's estate by the partnership***. The Entity (the business) applies for, owns, pays for, and is the beneficiary of the policy.*** This interest is then divided among the surviving partners in proportion to their own interests upon the death of one partner. One policy per partner.

Another option for funding this is a joint policy, first to die. There is one policy written on all partners and it pays when the first partner dies. In this type of buy-sell arrangement, the business itself purchases the ***shareholder's interest upon their death***. Death benefits are received federal income tax-free but may be subject to other taxes. Have your client consult a tax attorney or a CPA.

G. Social Security benefits

Social Security pays benefits when a covered worker retires (Medicare and retirement benefits), dies, or becomes disabled. It is funded by Social Security taxes and is also known as **Old Age Survivor Disability Health Insurance** (OASDHI).

Old Age — retirement
Survivor — pays the spouse and children if the worker dies
Disability — Disability Income
Health — Medicare (covered in another chapter)

- Other than Medicare where the benefits are the same for everyone, any other benefit payable is based on a person's PIA.

- **The Primary Insurance Amount** for a worker is based on his or her average level of earnings and is updated and published annually in tables by the federal government. ***Most types of Social Security benefits are a percentage of the individual's Primary Insurance Amount.*** (www.ssa.gov) ***Some benefits may be taxable.***

Qualification: To be eligible for any benefits, a person must become "insured" as defined in the Social Security law.

Fully insured means you are eligible for all the Social Security benefits. To become fully insured, you must work (and pay Social Security taxes) for 40 quarters. A quarter is ¼ of a calendar year.

When a worker dies, Social Security will pay an amount monthly to the spouse if there are children younger than age 16. Additionally, each unmarried child is paid a monthly amount until they reach age 18 or 19 and have finished school. There is a family maximum.

There is a one-time death benefit or funeral payment of $255 that the dependents need to apply for. This is the death benefit for the primary insured (who is currently receiving social security payments) and has not been increased since the system was first started back in the 1930s.

H. Tax Treatment of insurance premiums, proceeds, and dividends

1. Individual Life The truth is the IRS needs taxes to pay for government, well, everything. The IRS will not take from both sides of the product though, so if the money is taxed before something is purchased, the benefit will not be taxed. If the money is tax deductible (so no taxes have been paid on it) or tax-deferred, the benefit will be taxable. It can get messy when you mix the two, for example, in a deferred annuity. Then you have a mix of both taxable and nontaxable income from the same product.

a) Premiums are ***not tax deductible*** from the insured's income. This applies to individual policies as well as business plans, i.e., key person or insurance to fund a buy/sell agreement.

b) Premiums are tax deductible to the employer for employer sponsored and employer paid group life insurance plans. This is true for the first $50,000 of life insurance. Any coverage above the $50,000 may be paid for by the employer but the premiums for that excess coverage are taxable income for the employees. This is under section 72 of the IRC. Death benefits are still tax free.

c) Cash Values accrue ***tax-deferred*** in any insurance product, whether it is an annuity or an insurance policy with cash value. (Paying taxes on surrender of the policy, only on any amount over and above the premiums paid).

d) Dividends are received ***tax-free*** when a dividend is paid to a policy owner with a par or participating policy. You are participating in the profit of the company. This is for any dividend received that is less than or equal to the premium paid. If dividends paid are higher than the amount of premium paid, only that difference is taxable. ***It is considered a refund of excess or surplus premiums.***

Stockholders receiving a dividend will be taxed since that is pure profit as an owner.

e) Settlements or Death Benefits (Proceeds) are ***federal income tax-free to a beneficiary.***

- A life policy with no beneficiary means the proceeds go to the insured's ESTATE. This will lead to the value of the estate increasing and it now may be subject to federal estate tax.
- When a payout or settlement option is chosen, any **interest earned** will be **taxable,** but the death benefit remains federal income tax-free.
    - *For example, I am concerned about a person's ability to control the lump sum of the death benefit, so I have a settlement option to pay out the funds over 20 years. The portion that is principal is not taxed since it is the actual death benefit. The portion that is growth is taxed as it is paid out since it is interest earned.*

f) An annuity payout is the same as a settlement option, with one exception. Generally, money being paid into an annuity is done with after-tax dollars, so the return of the principal is not taxed. Since the money grows tax-deferred, when the interest is paid out, it is taxable. An annuitant may receive a check and 50% is principal and 50% is growth. Only the growth is considered taxable income.

- The exception to this is when the annuity is inside the tax-deferred bubble of a qualified retirement plan or a traditional IRA. When the money being paid in is tax deductible, the money coming out is all taxable.

g) Last In First Out (LIFO) or First In First Out (FIFO).

- **The first amount credited to an account is the premium.**
- **The last amount credited to an account is always considered to be the interest or growth.**

Withdrawals are another means of obtaining funds from the cash value account. A ***partial withdrawal*** *(A.K.A. partial surrender)*, available on universal life policies or annuities without a life payout option chosen, does not have to be repaid to the policy.

- If the policy is a **universal policy**, premiums are allowed to be withdrawn first from the cash value, then any withdrawals that exceed the premiums paid will be taxed. This is a **FIFO**, first in, first out, policy.
- If this is an **annuity**, the interest is paid out first when money is withdrawn. Since the funds have been growing tax-deferred, the owner now owes taxes on the amount of interest withdrawn. Premiums are after-tax dollars going in so they will not be taxed when being taken out and they will only be out of the account after all the interest is withdrawn. This is known as a **LIFO** or last in first out plan.
- If this is an annuity inside a qualified plan (401K for example) all the money being paid in is tax deductible, so all the funds coming out will be taxed as they are withdrawn.
- If this is a **MEC,** it is a **LIFO**.
- All the plans may have a 10% tax penalty on the taxable amount if the owner is not 59 ½ that year.

- On the other hand, loans have zero tax consequences, but they do have to be repaid and they do accrue interest.

h) Viatical Settlements Or Life Settlements : Taxes on these can be tricky. Consult a professional tax advisor or CPA. The amount of premium paid in is not taxable on the settlement. The amount of cash value that is greater than the premium is taxed at a normal rate. So far, this is exactly how taxes are when you surrender a policy for the cash value. The next step is to remember the insured is selling the face value of the policy at a reduced rate. The difference between the cash value and the amount paid at the sale results in another type of tax, capital gains.

2. Group Life Section 79 (IRC) For group life insurance, the **premiums** paid by the employer are deductible for the employer. The premiums are **not** considered as taxable income to the insured. This applies only up to the **first $50,000 of coverage**. Premiums paid for coverage over $50,000 are taxable as income to the employee. The cost of employer-provided group-term life insurance on the life of an employee's spouse or dependent, paid by the employer, is not taxable to the employee if the face amount of the coverage does not exceed $2,000. If the amount of coverage exceeds $2000, it may not exceed the amount on the employee and the premium will be taxable to the employee.

- ***Coverage in "excess" of these limits will cause a tax on the premiums paid for those benefits.***
- ***Death benefits remain income-tax-free.***

3. Modified Endowment Contracts (MECs)

This is essentially a life insurance policy that pays a death benefit to the beneficiary upon the death of the insured and has a cash value that can be withdrawn. The difference between a UL and a MEC is in the portion (premium or interest) of the money when it is withdrawn. A UL pays out the premium first (FIFO), and a MEC pays out interest first when funds are withdrawn (LIFO).

To counteract what was perceived as abusive use of single-pay, limited-pay, and universal life policies as short-term, tax-sheltered, cash accumulation or savings vehicles, Congress passed legislation, effective in 1988, modifying the tax law definition of a life insurance contract, and created a new class of insurance contracts called MECs.

The test for MEC status is called the ***Seven-Pay Test***. A contract **fails to meet the seven-pay test** if it accumulates amounts paid under the contract at any time during the first seven contract years exceeding the sum of the "net level premiums." The IRS considers such contracts "***over-funded,***" such as a single premium whole life policy. These life policies are now considered Modified Endowment Contracts.

For example, a policy has a net level premium of $1,000 per year; If in the first year there is more than $1000 in the cash value, or during the second year there is more than $2,000 in the cash value, or during the third year there is more than $3,000 the cash value … up to 7 years, it is a MEC. Once a policy is determined to be a MEC it is always a MEC. After 7 years, if it is not classified as a MEC, it never will be. *Yes, even if you trade it out for a different policy.*

The basic difference between MECs and other life contracts is the federal income tax treatment of amounts received *during the insured's life*. When received from MECs, certain distributions under the contract that are not generally subject to tax when received from other life contracts are subject to income tax and, in some cases, a 10% penalty. The 10% penalty applies to distributions taken before age 59½. **Amounts received under MECs are treated as income-first**. (They are taxed the same as "deferred annuities," LIFO).