Chapter X

Life Insurance in Estate Planning

A. Overview and Purpose

In this chapter we will examine the role played by insurance in a typical estate plan. We will begin our discussion by referring to key insurance terms in order to understand the differences in insurance products and roles the products can play. From that point, we will examine the various types of insurance products that are available in today's market place. After identifying the products, we will examine how these products can be used in an estate plan. Before deciding on their use, we will examine the tax impacts of using the product in estate planning. Finally, we will address the question of how much insurance to buy, and several factors that insurance buyers can use in deciding the amount of insurance coverage to purchase.

There are many useful references in books and on the Internet for people who want to know more about life insurance policies and purchase decisions The following web sites were consulted in preparing this chapter: "What You Should Know About Buying Life Insurance," found at www.pueblo.gsa.gov/press/nfcpubs/knowlife.txt and "Financial Guide: Life Insurance: How Much and What Kind to Buy," found at www.gofso.com/Premium/LE/08_le_bi/fg/fg-life_ins.html.

B. Lesson Objectives

When you have successfully completed this chapter, you will be able to accomplish the following objectives:

1. Distinguish among the various types of life insurance policies generally available to consumers today and the terminology that relates to these policies.
2. Discuss the role of life insurance in an estate plan.
3. Consider the state inheritance and federal estate, gift, and generation skipping transfer tax treatment afforded life insurance proceeds paid to a named beneficiary and to an insured's estate.
4. Distinguish between situations in which a person has incidents of ownership in an insurance policy from those in which a person has no incidents of ownership.
5. Describe the process consumers can follow and the factors they can apply in deciding how much insurance to purchase for their personal situation.

C. Insurance Terms and Definitions

Life insurance is one of the most common financial assets that people acquire during their lives, but it is unlike any other purchase that people generally make. When you pay the premiums, you're buying the future financial security for your family that only life insurance can provide. As a common financial asset, many people are familiar with basic policy types and insurance terminology. While many people feel they are knowledgeable about insurance, they often overlook the new types of insurance products and techniques developed over the last 20 years to serve a variety of financial planning needs and situations. Policy choices are much wider than simply deciding between whole life policies and term policies. To begin the discussion lets turn to some basic insurance terms and definitions.

Accidental Death Benefit–A provision added to a life insurance policy for payment of an additional benefit in case of death as a result of accidental means. It is often called "double indemnity."

Annuity–A contract that provides income either for a specified period of time or for a person's lifetime. Although annuities are financed by life insurance companies, annuities are the direct opposites of life insurance policies. Life insurance policies are payable at a person's death. Annuities are payable during lifetime.

Beneficiary–The person or entity, such as a trust fund, named in the policy as the recipient of the insurance proceeds in the event of the death of the insured person named in the policy.

Cash Surrender Value–The amount available in cash upon surrender of a policy before it becomes payable by death or maturity.

Convertible Term Insurance–Term insurance that offers a policyholder the option of exchanging it for a permanent plan of insurance without evidence of insurability.

Cost Index–A way to compare the costs of similar plans of life insurance and help you shop for a policy. One index is called a *net payment index* and it gauges the cost of carrying your policy for the next ten or twenty years. The lower the number, the less expensive the policy will be. The other type of index is a *surrender cost index*. This index measures cash value of a policy. This index may be a negative number and again the lower the number, the less expensive is the policy. These two indexes apply to term and whole life insurance policies

Face Amount–The amount stated on the face of the policy that will be paid in case of death or at maturity. It does not include dividend additions or additional amounts payable under accidental death or other specified conditions.

Grace Period–A period (usually 31 days) following each premium due date, other than the first, during which an overdue premium may be paid. All provisions of the policy remain in force throughout this period.

Guaranteed Interest Rate–The minimum interest rate that can be credited to a policy. On whole life and universal life policies, the guaranteed minimum is usually from 4% - 5.5%.

Guaranteed Insurability–An option that permits the policyholder to buy additional stated amounts of life insurance at stated times in the future without evidence of insurability.

Insured–The person on whose life an insurance policy is issued. The owner of the policy need not be the insured person on the policy.

Lapsed policy–A policy terminated at the end of the grace period because of non-payment of premiums.

Level Premium Insurance–Insurance for which the cost is distributed evenly over the premium payment period. The premium remains the same from year to year, and is more than the actual cost of protection in the earlier years of the policy and less than the actual cost in the later years. The excess paid in the early years builds up a reserve to cover the higher costs in the later years.

Mutual Life Insurance Company–A life insurance company whose board of directors is elected by its policyholders. Generally, these companies issue participating policies that entitle policyholders to share in surplus earnings through dividends reflecting the difference between premiums charged and the cost to the company of providing the insurance.

Non-Forfeiture Values–The value, if any, either in cash or in another form of insurance, available upon failure to make the required premium payments.

Nonparticipating Policies–Insurance on which no dividends are paid.

Optional Benefits–Benefits which are in addition to basic life insurance protection. Waiver of premium upon disability or some other event. Accidental death benefits are optional benefits.

Paid-up Additions–A dividend option that allows dividends on a participating policy each year to purchase small amounts of single premium life insurance on which no further premiums will be necessary.

Paid-up Insurance–Insurance on which all required premiums have been paid. Paid-up policies may be confused with vanishing premium option policies described below.

Participating Policy–Insurance on which the policyholder is entitled to share in the surplus earnings of the company through dividends that reflect the difference between the premium charged and the cost to the company of providing the insurance.

Policy Dividend–A return of part of the premium on participating insurance resulting from actual mortality, interest, and expenses that were more favorable than the corresponding assumptions used in determining the premiums.

Policy Loan–The amount that can be borrowed at a specified rate of interest from the issuing company by the policyholder using the value of the policy as collateral. If the insured dies with the debt partially or fully unpaid, the amount borrowed, plus any accrued interest, is deducted from the amount payable.

Renewable Term Insurance–Term insurance providing the right to renew at the end of the term for another term or terms, without evidence of insurability. The premium increases at each renewal as the age of the insured increases.

Rider–An amendment to an insurance policy that modifies the policy by expanding or restricting its benefits or excluding certain conditions from coverage.

Settlement Option–One of the several ways, other than immediate payment in a lump sum, in which the insured or beneficiary may choose to have the policy proceeds paid.

Stock Life Insurance Company–A life insurance company owned and controlled by stockholders who share in the company's surplus earnings. Generally, the company issues nonparticipating life insurance policies.

Term Insurance–A plan of insurance that covers the insured for only a certain period of time (the term), not for his or her entire life. It pays death benefits only if the insured dies during the term of the policy.

Term Rider–Term insurance that is added to a whole life policy at the time of purchase or that may be added in the future.

Underwriting (or **Risk Classification)**–The process of classifying applicants for insurance by identifying characteristics as age, sex, health, occupation, and hobbies. People with similar characteristics are grouped together and are charged a premium based on the group's level of risk. The process includes rejection of unacceptable risks.

Universal Life Insurance–A flexible premium life insurance policy under which a policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for increases) and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is credited at rates that may change from time to time.

Variable Life Insurance–Life insurance under which the benefits relate to the value of assets behind the contract at the time the benefit is paid. The assets fluctuate according to the investment experience of a separate account managed by the life insurance company.

Waiver of Premium–A policy provision that sets certain conditions under which an insurance policy is kept in full force and effect by the company without the payment of premiums. It is used most frequently for those policyholders who become totally and permanently disabled, but may be available in other cases.

Whole Life Insurance (or **Straight Life** or **Permanent Life)**–A plan of insurance for the whole of life, with premiums payable for life.

D. Types of Insurance Policies and Products

Life insurance is acquired by purchasing a policy, which is a contract between the insurance company and the policy owner. As a contract, its terms have special significance in defining the rights and responsibilities of the parties. When a policy is purchased the owner joins a risk-sharing group or life insurance company. The company agrees to pay the designated beneficiaries at the time of the insured's death an amount specified in the policy. This promise is made in return for the owner's promise to pay the agreed premium over the period specified by the policy.

Insurers gather information about applicants, such as age, gender, health, occupation and hobbies, so they can group together people with similar characteristics and calculate a premium based on the group's level of risk. Those with similar risks pay the same premium. This process is known as risk classification, and by providing equal treatment for equal risks, it allows insurers to treat policyholders fairly.

There are two basic types of life insurance - term and whole life insurance - and several variations of each type.

Term insurance is protection that insures a person for a specified period of time, usually 1, 5, 10 or 20 years, or up to certain age, such as 70. It is a policy that provides pure protection against an insured event occurring during the policy term. A term policy pays proceeds to the designated beneficiary if the insured person dies during the period the policy is in force. At the end of the term, the policy terminates, unless the policy has a renewable provision included in it. Under a renewable term policy, the insured need not provide evidence of insurability to renew it. Each time it is renewed, however, premiums can be adjusted higher.

Term insurance that is **convertible** can be exchanged for a whole life policy without providing proof of insurability, but at a higher insurance premium. Term insurance is initially cheaper than whole life insurance for the same amount of insurance coverage. It gives the largest amount of immediate coverage per dollar of premium spent. Term insurance is frequently used by consumers who need large amounts of coverage for known periods of time, such as home buyers or parents of young children.

Whole life insurance is protection that can be kept in force as long as the insured lives and the owner pays the premiums. By choosing to pay premiums that remain the same throughout the policy period, the owner averages out the cost of the policy over the insured's lifetime.

An important feature of whole life insurance is its **cash value**. Cash value continues to grow on a tax-deferred basis. If the policy is canceled and cash value is paid to the owner on a lump sum basis, the owner reports as income the amount by which the cash value, plus any dividends received, exceeds policy premiums paid. Insurance policies include tables that describe exactly how much cash value is in the policy. Cash value of whole life insurance policies can be used many ways.

> *Example: Using the policy as collateral, the owner can borrow the cash value from the insurance company.*
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> *If a premium payment is missed, the company, with the owner's authorization can draw from the cash value to keep the policy in force. Cash value can be used to purchase a paid-up policy that may lower the level of protection, but also remove the obligation to pay further premiums. Cash value can also be used to purchase an annuity that provides monthly income during lifetime. If a policy owner no longer wishes to continue the policy, the owner can surrender the policy to the company and receive its cash value remaining after surrender fees or charges are deducted.*

There are several variations on whole life insurance plans. One is **modified life**, which is a policy with a premium that is relatively low in the first several years of a policy, but goes up in the later years. This policy is attractive to people who want whole life insurance, but who want to pay lower premiums in the early portion of the contract.

Limited-payment whole life insurance policies provide protection for the life of the insured, but premiums are payable over a shorter time period–such as 20 years–or until the death of the insured. Since premiums are paid over a shorter period of time than for regular whole life policies, premiums are generally higher in such cases.

Single-payment whole life insurance provides protection for the life of the insured in exchange for the payment of the total premium in one lump sum amount. Under recent amendments to the Internal Revenue Code, policies that are paid-up in fewer than seven years are classified as "modified endowment contracts" and are subject to adverse income tax consequences if the owner makes loans against the cash value or withdrawals.

Combination term and whole life plans combine both types of insurance coverage in one policy. Through the life of the policy, coverage can be influenced by the rising cost of term coverage or a gradual conversion of term coverage to whole life coverage. In this context, the policy owner and insurance agent can plan to achieve their desired goal.

In recent years, a number of new insurance products have been developed to take advantage of consumer interest and financial opportunities available to insurance companies. These products are known as **universal life insurance, variable life insurance, and adjustable life insurance.**

Universal life is a policy that includes an investment program and a term insurance contract. These policies allow policy owners to pay premiums in virtually any amount, subject to certain minimums. The policyholder can also change the amount of insurance more easily than under traditional policies. In a universal life policy, the amount of the cash value reflects the interest earned at the prevailing interest rates. The level of cash value is "interest sensitive," which means that the amount accumulated varies according to the general financial climate. Rates are usually guaranteed for one year, and then a new rate is determined. Rates can go no lower than a guaranteed rate specified in the policy.

Variable life allows death benefits and cash values to fluctuate according to the investment experience of a separate account managed by the life insurance company. Policy holders have the opportunity to obtain higher cash values and death benefits than with policies calculating benefits based on a fixed rate of return. On the other hand however, policy holders also assume the risk of negative investment performance.

Two types of variable life policies exist: scheduled premium variable life and flexible premium variable life. Premium payments under a scheduled premium policy are fixed as to the timing and amount. Policyholders who own a flexible premium policy may change the timing or amount or both of their premium payments.

Adjustable life policies allow the policyholder to change the policy as his or her needs change. For example, if the owner wants to increase or decrease coverage, the owner can change the premium payment or change the length of time that the policy is in force. If the death benefit or amount of insurance is increased, the insured may have to provide evidence of insurability.

Other forms of insurance that are widely available include **second to die policies and split-dollar policies.** In a second to die policy, the insurance company's obligation to pay the policy proceeds is conditioned on the death of two people. Therefore, the obligation to pay does not arise until the second of the named insured dies. Second to die policies can be either term or whole life policies or any of the whole life variations, such as universal life. In addition, such policies can have other policy options. An advantage of second to die coverage is that the premium cost of such coverage is generally lower than the premium cost for single life policies. With two lives being underwritten, the poor health of one insured can be offset by the good health and life expectancy of the second insured.

Split-dollar life insurance policies are used to provide insurance coverage for major shareholder-employees of closely held or family owned business corporations. In such plans, the business advances a portion of the insurance premiums to the shareholder-employee. This amount may be the portion of the premium that reflects the increase in the cash value of the insurance policy during the period represented by the premium paid. At the insured's death, the corporation receives a portion of the insurance proceeds, such as the amount of the cash surrender value of the policy for the year in which the shareholder-employee dies, and the balance is paid to beneficiaries designated by the shareholder-employee.

E. How is Insurance Used in Estate Planning?

As the variety of insurance products indicates, insurance can play a very versatile role in an estate plan that addresses lifetime needs and opportunities and provides for the transfer of property after a person's death. First and foremost, insurance can provide significant funds at a time when they are needed most. Insurance proceeds may be the source of substantial wealth that is passed on to designated beneficiaries, whether family, non-family or charitable. Second, insurance can be used to create a fund that pays taxes, debts, or expenses generated during lifetime or created by the death of the insured. An insurance fund can also provide financial security for a surviving spouse or other person who is financially dependent on others or whose special needs require significant financial resources to deal with problems they present. Third, in the context of a closely held or family-owned business, insurance may provide the funds that younger generation owners need to acquire a business interest from a deceased parent or other family member and continue the business. In the context of family-owned businesses, not all children may have the interest or ability to successfully continue the business. Insurance proceeds can also be used to equalize the treatment of children who inherit a share in the business with children who are not involved in the business, but to whom the deceased owner wants to bestow a significant benefit.

Regardless of the objective chosen the recent amendments to the federal estate tax law will decrease the number of situations to which these taxes will apply. In turn, this will affect those estate planning situations in which insurance was used to fund the payment of large tax bills. As the tax bills decrease, the impact on the need for insurance will depend on an individual's own situation. If Congress allows the estate tax to return to effectiveness on January 1, 2011, individuals may find themselves in a situation where a return to threats of large tax bills may occur. For many people this uncertainty will be a major obstacle for meaningful planning over long periods. The next chapter will address some of the estate planning strategies that can be used to address this uncertainty.

F. Inheritance, Estate, and Gift Tax Impacts of Using Insurance

For state inheritance tax purposes, receipt of life insurance proceeds following an insured's death, whether from separate insurance policies or policies that are part of a retirement plan, may or may not be subject to state inheritance tax. A different result could apply if the proceeds are paid to the deceased person's estate rather than a named beneficiary. Therefore, it is important to check on the treatment that applies in a specific state.

For federal estate tax, several issues arise concerning insurance proceeds. For estate tax purposes, proceeds of life insurance policies paid to or for the benefit of the decedent's estate or over which the decedent is considered to hold the incidents of ownership are included in the decedent's gross estate for estate tax purposes.

Proceeds payable directly to the personal representative of the decedent's estate or payable to a person who is subject to a legally binding obligation to pay taxes, debts, or other charges enforceable against the estate are considered payable to or for the benefit of the estate. The concept of incidents of ownership of a policy looks to the deceased owner's ability, acting either alone or in conjunction with another, to determine who or what receives the economic benefit of the policy. Authority such as designating a beneficiary, surrendering or canceling the policy, assigning the policy or revoking an assignment, pledging the policy for a loan or borrowing against the cash surrender value of the policy is generally considered to be an incident of ownership. If the policy provides it or its proceeds can return to the decedent or the decedent's estate, or the decedent's estate has a power of disposition over the policy, the holder of such power is considered to have an incident of ownership if either of these powers is valued at more than 5% of the value of the policy immediately before the decedent's death. These powers are referred to as **reversionary interests**. A person who has incidents of ownership can irrevocably assign the policy to another to avoid the inclusion of policy proceeds in a gross estate.

In Chapter IX, the concept of an **irrevocable life insurance trust** was introduced. The objective of this approach is to make the trustee the owner of a life insurance policy that will eventually fund the trust when the insured person dies. By having the trustee be considered the policyowner, the individual who sets up the arrangement avoids having the proceeds of the policy being included in his or her gross estate for federal estate tax purposes while still having some control over the ultimate destination of the policy proceeds when the trust agreement is prepared. Once the policy proceeds are received, the trustee manages the proceeds for the benefit of the persons named in the trust agreement and distributes the funds according to those terms. If a surviving spouse is given an interest in the benefits of the trust care should be taken to avoid the trust proceeds from being considered as part of the spouse's estate where it may create a significant tax. The earlier discussion in Chapter IX of a by-pass trust is relevant to this discussion as well. Under the terms of the trust agreement the trustee can be given authority to purchase assets from the estate and provide cash to the estate. Drafting the irrevocable life insurance trust agreement is an important component in making this plan a success. Care must be taken to draft the plan to achieve the desired goals while avoiding the pitfalls that could create unintended and undesirable results.

A second estate tax consideration involves gifts of insurance policies within three years of the decedent's death. Under current estate tax law, such gifts, as well as several others, are included in the gross estate despite the transfer of the property before death. Policy proceeds will generally be included in the gross estate of the decedent who dies within three years of transferring the policy even though the recipient of the policy pays the insurance premiums during the three-year period. Therefore, if a policy owner assigns or transfers the policy to another person to avoid having the policy proceeds included in his or her estate, the three-year rule becomes an important consideration.

For gift tax purposes, the lifetime transfer of life insurance policies is a potentially taxable transfer if the value of the gift exceeds the gift tax annual exclusion. Gifts of insurance policies can be either direct or indirect. A transfer from a policy owner, who is also the insured, to another is an example of a direct transfer. Similarly, if a person purchases a policy of insurance on his or her life and names another as the beneficiary, a gift occurs regardless of whether the beneficiary is named directly, or as the beneficiary of a trust. Examples of indirect transfers are payment of another's insurance premium, transfer of employer provided group term coverage from the employee to another, split-dollar insurance coverage arrangements between a corporation and another who is not an employee of the corporation, such as the spouse of an employee. In these gift situations, a central concern is the value of the gift in relation to the annual exclusion amount that determines if a taxable gift is made.

For gift tax purposes, insurance policies are valued at their fair market value that is its actual cost or replacement cost. The value of a particular type of policy is determined by establishing the cost of comparable policies issued by other companies. If the policy is a whole life policy in force for some time, however, it may be necessary to determine the terminal reserve value of the policy and then adjust that amount by adding unearned premiums and dividend accumulations and deducting policy loans from the total. The value of certain types of policies may also reflect their unique character. Since term insurance policies have no terminal reserve value, their fair market value is the value of their unearned premium at the date of the gift. Newly issued single premium policies are valued at the amount of the premium paid. If a policy has been in force for some time and is paid-up, its value is the single premium or charge that would be charged by the issuing company, at the date of the gift, for a policy with the same face amount and based on the insured's age at the time of the gift. Employer-provided group term insurance coverage is valued at the amount of the unearned premium on the date of the gift. Whole life insurance subject to a split-dollar arrangement is valued as other whole life policies, but the amount of the employer's interest in the policy is deducted.

A second gift tax consideration is that the recipient of the gift must have a present interest in the gift property for the annual exclusion to apply. Outright gifts of insurance policies to recipients qualify as present interests if the recipients have the unrestricted right to the use, possession, and enjoyment of the policy, even though the death proceeds may not be payable to a later time. Transfers of life insurance policies in trust must also meet the present interest requirement to qualify for the annual exclusion. To create the present interest, gifts in trust can provide for the beneficiary's right to withdraw an annual amount small enough to avoid being treated as a taxable gift or a general power of appointment over the trust if the failure to exercise the right to withdraw is treated as the lapse of a general power of appointment.

For generation skipping transfer tax (GSTT) purposes, a trust includes any arrangement (other than an estate) that, although not a trust, has substantially the same effect as a trust. Insurance is specifically subject to this treatment. Therefore, life insurance policies that are not held in trust, but that have substantially the same effect as a trust (income to a person for life, with principal paid to others at the person's death) may be subject to GSTT.

In considering the impact of generation skipping transfer tax on insurance, several issues arise. The first involves the effective date of GSTT provisions. GSTT does not apply to a trust that was irrevocable on or before September 25, 1985, and that had no additions to the trust after that date. Additions after September 25, 1985 may result in a portion of the trust being subject to GSTT. Constructive additions to an exempt trust occur where release, exercise, or lapse of a power over a portion of the trust is treated as a taxable transfer. This may result in the portion of the trust subject to the power being treated as an addition to the trust.

Gifts of property below the annual exclusion amount for gift tax purposes are also exempt from GSTT provided they are treated as direct skips. Direct skip gifts can be gifts made directly to a skip person or to a trust for the benefit of one or more skip persons and in which no non-skip persons have an interest. Direct skip gifts below the $10,000 annual exclusion amount ($11,000 after 2001) made to a trust after March 31, 1988, may also be exempt if the trust is structured so that during the life of the individual beneficiary no portion of the principal or income of the trust may be distributed to or for the benefit of any person other then the beneficiary. If the beneficiary dies before the trust is completely distributed, the trust must provide that the remaining trust assets are to be distributed to the beneficiary's gross estate and potentially subject to estate tax at that time.

Therefore, a gift by a grandparent to a trust established for a grandchild that qualifies for the annual exclusion by reason of the grandchild's present interest in the trust may also qualify for the GSTT exemption. If the trustee chooses to purchase life insurance with the trust principal, the funds used to pay insurance premiums will avoid GSTT. Since the funds are received by the trust as nontaxable gifts, the policy proceeds will likewise be nontaxable for GSTT purposes.

Nontaxable gift situations may benefit from considering second to die life insurance policies that take advantage of the lower premium costs which such policies often offer. As such policies pay proceeds only at the second death, the financial circumstances of intended beneficiaries must be able to deal with that fact. Similar results may be obtained by using split-dollar arrangements between the insured's employer-corporation and an irrevocable life insurance trust. In an appropriate situation, combining both techniques may drive premium costs down even further.

G. How Much Life Insurance Should I Buy?

Buying life insurance, like many other financial purchases, is an individual decision, based on particular circumstances and needs. For example, term insurance is useful on a temporary basis if a person is young and wants to provide for a spouse and young children should he or she die unexpectedly. For young, healthy people, it is relatively inexpensive. For older, more established people, the cash value and fixed premiums of a whole life policy might be more attractive. The flexibility afforded by universal and variable life policies may respond to individual needs more effectively. For older persons, insurance may be very difficult to get, especially in the case of someone who suffers significant illness or injury that makes insurance very expensive, or even impossible to buy. The *Financial Guide's* "Life Insurance: How Much and What Kind to Buy" website considers five typical situations in which life insurance might be considered and how the situation might impact on the amount of insurance to purchase. These five situations include:

1. Families or single parents with young children or other dependents
2. Adults with no children or other dependents
3. Single adults with no dependents
4. Children
5. Retirees

Without considering other factors, of these five groups the group with the greatest need for life insurance is the first group. People in the second group may view insurance as an important tool to replace the income support lost by a spouse's death or as a means to provide a supplement to a surviving spouse's retirement plan. Children have perhaps the lowest need for life insurance. Retirees may have less need for life insurance unless they view it as a source of funds for a variety of estate taxes and expenses such as, planning for retirement purposes, funding payment of death taxes, purchasing shares of stock or partnership shares in a business, creating the instant estate, or making special gifts to special people. This classification process simply helps someone to consider how their individual circumstances and situations impact on their need for life insurance.

In deciding how much insurance to buy, the first step should be to determine your insurance needs. What purpose or role do you expect the insurance to serve in your overall estate or financial plan? Up to this point we've discussed several roles that insurance can play, such as creating the estate that will pass to the beneficiaries, providing financial security for a financially dependent spouse or beneficiary, providing a fund from which major bills such as a mortgage or a deceased owner's share of a business can be paid, or payment of an anticipated expense, such as a college education. Life insurance also plays a role in retirement planning by allowing individuals to maximize their existing retirement benefit plans.

After deciding the role insurance is to play, the next step is to review your present resources to determine your financial situation. Completing the estate summary and estimate of annual income and expense found in Chapter XIII is an excellent way to organize and analyze your personal financial situation. Once you have the information organized, look for key points in the summaries.

> *Example: If your assets exceed your liabilities by a significant amount, your financial situation may be pretty good. How will the death of the sole property owner, or one spouse, affect that situation? What taxes will be imposed on the transfer of property from the deceased owner to whoever is intended to receive it? How will taxes be paid? Will it be necessary to sell valuable assets to pay the tax? Will the sale of these assets affect the surviving spouse's income level? If the income level is reduced, will it be sufficient to maintain the life style enjoyed while both spouses were alive*?

In considering these questions, the annual income and expense estimates in Chapter XIII are convenient and helpful guides to determining the present situation and estimating the effect of the loss of one spouse's income on the survivor's financial situation. If additional resources must be found to cover expenses or maintain income levels, a review of alternatives will identify the potential sources of additional resources.

After examining the role that insurance can play and examining the present asset and anticipated income and expense situations, the next area to consider is the amount of personal or family resources that can be devoted to purchasing insurance. Without considering the ability to pay factor, a purchase decision can quickly become a financial mistake that leads to canceling the insurance and significant loss of premium and insurance protection. If ability to pay is limited, it may mean that the purchase decision should be to purchase the best available insurance product that provides the desired level of protection and financial benefit. Insurance products can be expanded or modified in the future, and it is generally better to accomplish part of a goal than to leave it completely unaccomplished.

The decision to purchase insurance should be made only after a thorough consideration of these three factors: the role of insurance, the financial situation at present, and, as anticipated in the future, your ability to pay.

Once the decision is made to purchase insurance, the buyer's attention should focus on purchasing the best policy from the best company with available premium dollars. This consideration looks at two factors: the policy that is being offered and the company that is offering it. To help buyers compare insurance policies a cost index has been developed and an insurance company can calculate an index for a particular policy. This allows buyers to compare the cost index from one policy to the index of similar policies from other companies. In making the comparison, a policy with a lower index is generally a better buy than a policy with a higher index. Additional information about the cost index method of comparison can be obtained from an insurance agent, an insurance company, or a state insurance department or office. In making comparisons between policies, remember the following rules:

- Cost comparisons can only be made between similar life insurance policies.
- Index number comparisons should only be made for the insured's age, for the kind of policy you intend to buy and for the amount of insurance you plan to purchase.
- Small variations in index numbers might be offset by other policy features or differences in the quality of service you get from the company or the agent.
- Base a decision not only on a low index number, but also on whether the policy meets your needs; whether you can afford the premium; and whether you understand its cash values, if any, its dividends, if any, and its death benefits.
- The cost index cannot be used to compare existing policies to newly issued policies. Therefore, it cannot be used to determine whether a current policy should be replaced by a new policy.

After obtaining the cost index information from the companies in which you are interested, a buyer also should examine the strength of the company issuing the policy. An essential assumption in using life insurance is that the company is financially sound and will be available to pay the policy when the time comes to do so. This company analysis can be done by consulting one or more of the insurance rating services that analyze and rate life insurance companies in the United States. These services include Best's Ratings, Moody's Investors Service, and Standard and Poor's. Best's Ratings are prepared by A.M. Best for over 1,400 life insurance companies and their ratings range from its highest rating of A+ to the lowest rating of C. Generally, over 200 companies receive the A+ rating. Moody's Investor Service rates fewer life insurance companies than A.M. Best and its ratings range from a high rating of AAA to a low of C. Standard and Poor's ratings of life insurance companies range from a high of AAA+ to a low of D. It is important to remember that the rating scales vary from one company to another. An A+ is the highest rating issued by A.M. Best, but third from the highest in the Standards and Poor's rating system.

Before deciding on the policy and company that best accomplishes your goals and fits your budget, it would be useful to read the insurance contract carefully. At this point in reading through this chapter and at this point in the book you are probably saying to yourself, “Why would someone ever want to read an insurance contract if I am not going to understand what it says"? While it is certainly true that insurance contracts are complex and difficult to understand, the fact remains that much valuable information can be learned from reading over them. As a contract, the terms and conditions set forth in the policy are very important in defining the rights and responsibilities of both the company and the policy owner. If policy terms and conditions are unclear, important elements of an informed purchase decision may be missing from the decision-making process. Reading through the contract will help to highlight key questions that must be resolved before a final decision can be made.

To summarize the many factors and issues, before purchasing a policy, buyers should follow these 10 rules developed by the American Council of Life Insurance:

1. Understand and know what your life insurance needs are before purchasing any policy. Choose the company that offers policies that address those needs.
2. Buy life insurance from a company that is authorized to do business in your state.
3. Select a competent, knowledgeable, and trustworthy insurance agent.
4. Shop around and compare the cost of insurance policies.
5. Buy only the amount of life insurance that you need and can afford.
6. Be certain to inquire about lower rates for special groups, such as non-smokers.
7. Read and understand your insurance policy.
8. Inform your beneficiaries about the kinds and amounts of life insurance that you own.
9. Keep insurance policies, a separate list of the companies that issued the policies and a list of policy numbers in a safe place.
10. Check insurance coverage and designated beneficiaries periodically, to be sure that coverage is proper and the beneficiaries are people you want to benefit.

H. Student Exercises

Multiple-Choice Questions

Please read the following questions carefully, then select one of the four choices following the question that best answers the question asked:

1. Which of the following statements is incorrect?
   a. The beneficiary of a life insurance policy is the person who receives the proceeds of the policy after the owner's death.
   b. Cash surrender value of a life insurance policy is the amount payable by the insurance company to the beneficiary.
   c. Term insurance does not have cash value.
   d. Annuities are contracts that pay income to someone during their lifetime and are unlike insurance policies that pay proceeds after a person's death.

2. Which of the following terms describes a life insurance policy that accumulates cash value?
   a. A convertible term policy
   b. A permanent life insurance policy

c. A renewable term policy
d. A participating policy

3. Which of the following terms describes an insurance policy that covers the lives of two people and that is payable only after both people have died?
   a. A variable life insurance policy
   b. A universal life insurance policy
   c. A split-dollar life insurance arrangement
   d. A second to die life insurance policy

4. If a deceased person is considered to have the "incidents of ownership" of an insurance policy at the time of his or her death, the policy proceeds will be included in the decedent's gross estate for federal estate tax purposes. In which of the following cases would the decedent not have incidents of ownership?
   a. The decedent is authorized to designate beneficiaries of the insurance.
   b. The decedent pledged the policy as security for a loan.
   c. The decedent is authorized to cancel the policy at any time during his lifetime.
   d. The decedent paid none of the policy premiums and had no authority to deal with the policy in question.

5. Gifts of life insurance policies valued for less than $11,000 may qualify for the annual exclusion from federal gift tax. Which of the following statements correctly describes a requirement for application of the annual exclusion?
   a. The gift must be made within three years of the owner's death.
   b. The recipient must live for three years after the gift is made for the annual exclusion to apply.
   c. The recipient must have the unrestricted right to use, possess or enjoy the insurance policy after the gift is received.
   d. The donor may make only three such gifts in a calendar year.

Short-Essay Questions

Please read the following questions carefully and then respond to the question that is asked at the end of the situation. Your answer need not be long or involved, but it should be clear and concise. If you want to refer to important facts in your response, please feel free to do so.

6. John and Mary operate a farm and woodlot with the help of their daughter, Marcia, and their son, Michael. John and Mary have two other children, Martin and Martha. Neither of these other children are interested in working in the business. They are financially independent and involved in their own careers.

   If John and Mary intend to transfer the land, business assets, and equipment to Marcia and Michael, almost the entire estate will be transferred to these two children. If John and Mary don't want to ignore their other children, discuss the role that life insurance can play in enabling John and Mary to provide for post death transfers to Martin and Martha.

7. In 1986, Harold Humphries purchased a $100,000 whole life insurance policy on his life and named his wife, Harriet, as beneficiary. At the time, Harold was not aware that Harriet secretly desired to end their marriage of five years. Harriet's heart belonged to another, but Harold didn't know this.

   When he purchased the policy, Harold retained the right to name the beneficiary and to borrow against the cash value of the policy. Harold considered the cash value a valuable investment that also provided insurance protection in the event of his death.

   In 2000, Harriet confronted Harold and told him of her desire to end their marriage. Harold was heartbroken, but he knew he could not change Harriet's mind. The divorce became final on December 1, 2000 and Harriet married the man she secretly loved.
   In March 2001, while traveling to town to pick up parts for his machinery, Harold was involved in an accident and suffered fatal injuries. At Harold's death he was survived by his brother, Hank, and his sister, Hildie. No children were born to Harold and Harriet during their marriage. Harriet, now married to her new husband, Herb, also survived.

   After Harold's death, Hank and Hildie went through Harold's papers and found the insurance policy. Hank notified the company of Harold's death. The insurance company then notified Harriet that she was the beneficiary of the policy and made arrangements to pay the proceeds to her.

   Based on our discussion of state inheritance tax and federal estate tax, discuss the impact of these taxes on Harold's estate and on Harriet.

8. Over the years, Jerome Jaxsenn and his wife Jennine have often considered the need to purchase additional insurance. The needs they want to cover include the cost of inheritance and estate taxes and providing significant gifts to their two children, both of whom owe considerable amounts in student loans for their professional educations. If either Jerome or Jennine were to die, the survivor would be financially able to manage on their own.

   The difficult questions concerning insurance coverage have always been, "How much insurance should we buy, and from which company should it be purchased?" Based on our discussion of the types of insurance policies, comment on the types of policies that would fit the Jaxsenn's needs. Briefly outline the steps they should take as they evaluate their purchase of a new insurance policy.