

**DOHRN INSURANCE TRAINING, INC.
8517 WEST GRAND AVENUE
RIVER GROVE, IL 60171**

847-455-1130

PRELICENSING:

LIFE

INSURANCE

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ILLINOIS INSURANCE LAW

THIS SECTION IMMEDIATELY FOLLOWS THE
LIFE MULTI-STATE PART ONE TEST MATERIALS,
ABOVE THIS IS PART II OF YOUR STATE EXAM

EXAMINATIONS

THIS SECTION IMMEDIATELY FOLLOWS THE ILLINOIS LAW SECTION
AND CONSISTS OF THREE EXAMS. THE FIRST ONE IS THE
NONSUPERVISED EXAM AND IT MUST BE COMPLETED AND RETURNED TO
Dohrn Insurance Training TO RECEIVE CREDIT. THE OTHER TWO PRACTICE
EXAMS ARE SELF SCORING AND MUST BE COMPLETED TO ASSURE
PASSING THE PROMISSOR STATE INSURANCE EXAM.

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READ THIS PAGE FIRST

WHETHER YOU ARE ATTENDING THE ONE DAY SEMINAR OR COMPLETING THE COURSE VIA SELF STUDY:

Read through all materials pertaining to the license you wish to obtain (life, accident & health, property, casualty).

Complete the "NONSUPERVISED" exam in an open book fashion. THIS EXAM WILL BE GRADED BY DOHRN INSURANCE TRAINING. The "NONSUPERVISED" exam is the first exam in the EXAM SECTION located in the read of your text (immediately following the gold sheet in book form). You must score 70% or better on any life, accident & health, property or casualty NONSUPERVISED exam in order to pass your prelicensing course! If you fail this exam you will be sent a make-up exam. If you fail the make-up exam you must take a prelicensing course from a different provider and attempt to pass their course. **KEY >> THIS IS AN OPEN BOOK EXAM! LOOK UP THE ANSWER IF UNCERTAIN –DO NOT GUESS!**

YOU MUST PASS YOUR PRELICENSING COURSE before your license can be issued. Upon passing this prelicensing course, Dohrn Insurance Training will report your course completion date via the Internet to the Illinois Department of Insurance. **We report course completions to the Division of Insurance every weekday.** Upon successful course completion **we will send you a confirmation letter** showing your completion date plus a list of incorrectly answered questions. **Once the Department of Insurance receives our report IT WILL TAKE THEM ONE OR TWO DAYS TO DOWNLOAD THE REPORT AND KNOW THAT YOU HAVE PASSED A PRELICENSING COURSE.**

ALL NONSUPERVISED EXAM ANSWER SHEETS must contain your name AND signature or your request for course completion cannot be honored. You also need to complete the reverse side of the exam answer sheet so that DOHRN knows how to contact you with NONSUPERVISED exam results in a timely fashion.

If you provide us with the proper information we will grade your exam, contact you and provide you with a list of all incorrectly answered NONSUPERVISED exam questions. Please review all missed questions, since these will probability indicate any weakness you may have.

AFTER COURSE COMPLETION, BUT BEFORE TAKING THE STATE EXAM:

- 1) AFTER YOU RECEIVE YOUR NONSUPERVISED EXAM RESULTS FROM DOHRN, REVIEW ALL STUDY MATERIALS AND NOTES AGAIN.
- 2) **The final practice tests for you to complete are the ones marked "SIMULATED".** The answers are provided and these exams should be completed and scored by you about one or two days before you sit for the state exam. Take this exam in "closed book" fashion. By reviewing all missed questions and analyzing the reason you selected an incorrect answer, you will learn from mistakes before they actually count.

ABOUT SCHEDULING FOR THE STATE EXAM:

*** YOU SHOULD PASS THIS PRELICENSING COURSE BEFORE YOU TAKE THE STATE TEST.

*** DON'T FORGET: IF YOU SCHEDULE YOURSELF AND DO NOT SHOW FOR THE PROMISSOR EXAM, YOU WILL PAY THE FEE ANYWAY UNLESS YOU CANCEL OR RESCHEDULE AT LEAST 4 BUSINESS DAYS IN ADVANCE.

PROMISSOR test centers are located throughout the state (as well as in Schererville, IN and St. Louis, Mo) but the CURRENT (AS OF 1/1/07) main locations are:

Downtown Chicago/ Schaumburg/ Oakbrook/ Springfield.

TO REGISTER FOR YOUR STATE EXAM WITH PROMISSOR CALL

800-274-0402

FOR OTHER INFORMATION CALL 800-274-1257.

You can access all test information, including online registration information by going to the PROMISSOR website at:

<http://www.promissor.com/>

For the latest course information from DOHRN INSURANCE TRAINING, INC, including all updated materials if changes occur can be accessed by visiting our Web Site:

www.dohrnit.com

Remember....Don't say "Darnit!"

....GO TO DOHRNIT!

STRUCTURE OF THE PROMISSOR INSURANCE EXAMINATIONS

This page illustrates how the PROMISSOR, the testing company THE STATE OF ILLIOIS has contracted with, formats insurance exams. Use the handy reference chart, below, to identify the actual number of questions for which you will be held responsible for each exam and part.

Each of the five insurance exams (Life, Accident & Health, Property, Casualty or Personal Lines) **are divided into two parts** called PART I and PART II. **PART I is referred to as the “multi-state”** section of the course and the questions pertain to generic insurance concepts relating to the particular testing subject (i.e. Life, Accident & Health, Property or Casualty). The material upon which the questions are based would be similar from state to state. **PART II, however, is state specific law** and questions here pertain only to the insurance law of your particular testing state (i.e. Illinois).

YOU MUST PASS BOTH PART I AND PART II OF A PARTICULAR INSURANCE EXAM IN ORDER TO BE ENTITLED TO APPLY FOR THE LICENSE. Should you fail one part but pass another, you may return within 90 days and retake only the part you failed without being required to retake the part you originally passed. However, a full test fee will be charged for any exam retake.

NUMBER OF TEST QUESTIONS, PER PART AND PER EXAM ARE AS FOLLOWS:

PART I (MULTISTATE)	LIFE	ACC&Health	PROPERTY	CASUALTY	PERS LN
Total Number of Questions that COUNT in your score	50	50	50	50	75
Total “PRETEST” Questions (Do not count in your score)	10	10	10	10	11
PART II (STATE LAW)					
QUESTION WHICH COUNT	31	39	30	37	36
PRETEST QUESTIONS	8	8	7	7	

Of the law questions cited above as “questions that count,” **22 are common to all lines of insurance** while the remainder are specific to the line of insurance.

PROMISSOR uses a method called “scaled scoring” to determine whether or not a candidate has passed an exam. These means tests are statistically analyzed based on the weight given individual questions in the scoring process. Therefore, **straight percentage scoring is not used** (i.e. 70%, 75%, etc.)

“PRETEST” questions, although they do not count in your score, **will not be identified as such** and the test candidate is advised to approach answering all questions with equal intensity.

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INTRODUCTION - PURPOSES & BENEFITS OF LIFE INSURANCE

1) INCOME REPLACEMENT – In the event of premature or unexpected death the income of the insured, income to which family survivors have grown accustomed, will end. A large lump sum of tax free dollars will be a valuable asset that can be invested to help offset the income lost through death.

2) IMMEDIATE CREATION OF AN ESTATE - life insurance death benefits provide an exact fixed number of dollars which are available at death, whenever it occurs, for any purpose desired.

3) PROVIDES CASH TO MEET FINAL (DEATH) EXPENSES - it buries you and pays off the credit cards, etc.

4) PROTECTS BUSINESS & INDUSTRY FROM ECONOMIC LOSS DUE TO DEATH OF A KEY EMPLOYEE - tens of millions of small business in America can stay in business because of death benefits paid.

5) INDIRECT SOCIAL BENEFIT - PREMIUM DOLLARS INVESTED BACK INTO THE AMERICAN ECONOMY (I.E. BUILD OFFICE BUILDINGS, SHOPPING CENTERS, ETC.) - Insurance companies are "financial intermediaries" (they play a financial role which is similar to banks).

LIFE INSURANCE

SECTION I: Types of Policies and Coverage

(9 QUESTIONS - 18% OF STATE EXAM)

OVERVIEW OF SECTION I: This content area will enable you to understanding the similarities and differences between main policy types. The main concepts are whole life versus term life; interest-sensitive life products, combination plans and annuities.

A) Traditional Whole Life (WL) Products

1) Ordinary (Straight) life - All Whole Life is also known as "**permanent**" insurance. You can never outlive the coverage and if you live to the "**endowment point**," the death benefit is paid to the policyowner. Otherwise if an insured dies before reaching the age of endowment then the full face amount (or death benefit) is paid to a named beneficiary or to the estate of the insured if no named beneficiary is alive at the time of death of the insured. The technical word for this death benefit payout is "**proceeds**." If the term proceeds is used it means the insured is dead.

WL offers life insurance ("death benefit") coverage for an individual's entire life (currently up to **age 100**).

A "level" (same amount) premium is payable each year until age 100 for "straight" life.

If the insured reaches age 100, the cash value of a traditional WL policy equals and pays the death benefit.

This is known as the "ENDOWMENT POINT" and the death benefit is paid in a lump sum to the owner.

ALL WL has 3 Common Characteristics

- **Level (guaranteed cost) premium** - same premium payment amount is due each year.
- **Fixed/constant & guaranteed amount of "death benefit."**
- **Cash Surrender Value (CSV)** which constantly grows and accumulates within the policy on a TAX-DEFERRED income tax basis. If a policy is surrendered prior to maturity, the policy holder may "cash in" the policy for the existing CSV. CSV increases each year premiums are paid. **At age 100 the CSV equals death benefit.** Cash value of WL is also referred to as a "savings feature" or "policy account."

INSURANCE TAX POINT: If the policy owner cashes a policy and receives more than total premiums paid, the extra money is income and taxable at ordinary income tax rates. The 100 year old who lives to policy endowment point must pay income tax on all money received which is in excess of total premiums paid.

2) Limited Pay and Single Premium Whole Life

■ **Limited Pay Policies (other than SPWL)** insurance coverage is provided for the insured's entire life but **premium payments are condensed and are paid in a shorter time frame than over the entire lifetime of the insured**. Therefore, the **regular annual premium installments paid are higher than for straight life** (and, of course, less than the one time cost of SPWL), but a fewer number of installments are made over time. **The name of the plan (below) reveals the premium payment time frame:**

- ➔ **10 Pay life** - pay for ten years, covered for entire life, **endows at age 100**
- ➔ **20 Pay life** - pay for twenty years, covered for entire life, **endows at age 100**
- ➔ **Life Paid @ Age 65** - pay until insured attains age 65, covered for entire life, **endows at age ?**
(That's right, age 100)

■ **Single Premium Whole life (SPWL)** is the purchase of WL coverage in a lump sum (with just **one premium** payment made!). However, it requires a large cash outlay at the initial purchase point. The death benefit protection continues during the insured's lifetime and the **endowment point remains age 100** (which is the endowment point for all WL contracts).

3) Adjustable Life

■ Introduced in 1971, **this policy allows the owner to change the plan of insurance** by increasing or decreasing face amounts and premiums, within certain limits. The protection period can also be lengthened or shortened by the owner. Depending upon the insured's face amount and premium payment amount selected, **the contract could resemble and perform like a term, straight WL or a limited pay life** policy, depending upon the needs and budget of the policyowner at any given time. Normally any adjustment that may increase the risk of an insurer (such as increasing the policy face amount or decreasing the premium payment) can require proof of insurability (continued good health since the policy was originally issued) by the insured before a company will agree to such changes.

B) Term Life Insurance = NO CASH VALUE! (Make and keep this association at all times!)

Term is **temporary** life insurance protection for a **specified period or "term" of time**. The **death benefit is only paid if the insured dies during the contract period and all premium has been paid in a timely fashion**.

>TERM plans do not develop any cash surrender AND therefore DO NOT provide nonforfeiture values. <

The purchaser is **ONLY exchanging premium dollars for death benefit** coverage and policy expense, **NOTHING ELSE**. >*Term is low cost life insurance when compared with Whole Life because in a term policy, the owner is not paying extra for a cash value building element.*

The cost of coverage per thousand dollars of insurance is **quite low for young purchasers** but **can become very costly for older insureds**. The **cost increases** upon contract renewal as the insured grows older simply **because the risk of death increases** with each passing year of life.

1) TERM VARIETIES – Level, Decreasing and Increasing

■ **Level Term** (the **death benefit is level** during the term of coverage). There is a level and specified amount of death benefit during the contract period. Level term commonly is issued for periods of years, i.e. 1, 5, 10, 15, 20, 25 or 30. **The longer the period of years selected, the higher will be the initial premium charged per year**. The higher cost for longer coverage periods is based on averaging the period involved and paying the same cost each year (level cost may not be part of the contract unless a "Guaranteed Level Term" contract is selected at a higher premium cost).

☞ **Example:** 5 yrt ("five year renewable term") or 10 yrt. At the end of 5 or 10 years the premium increases for coverage for the next 5 or 10 year contract period. Level term coverage averages the cost for the term period.

On the other hand, level term known as YRT or ART (yearly or annual renewable term) allow, after each year, the insured to elect to renew the coverage for one more year at a (slightly) higher price to account for the increased risk of dying.

■ **Decreasing Term** (the death benefit decreases over the term coverage period, but the premium charge remains constant from year to year over the entire coverage period). The face amount of insurance decreases from year to year until it reaches zero at the end of the contract period. Although the **premium charge is the same year after year**, the cost "per thousand" dollars of coverage is actually increasing each year since the same premium amount is paid annually for less and less death benefit. Typical coverage periods are 10, 15, 20, 25 and 30 years

☞ **Example:** A 20 year decreasing term plan is purchased at an annual cost of \$300 for \$50,000 of initial death benefit. If this is a "uniformly decreasing" term plan, then in 10 years the insured will still be paying \$300 annually but for only \$25,000 of benefit (because annually the face amount of coverage would decrease by \$2,500 - \$50,000 divided by 20). In this example, the cost per thousand is actually doubled in 10 years.

There are two basic types of decreasing term:

- **Uniformly Decreasing Term** - the death benefit decreases by the exact same number of dollars each and every year.
- **Mortgage Decreasing Term** - the coverage amount remains proportionately higher in the early policy years and then quickly drops during the last years of coverage. In this manner it **operates like a typical "AMORTIZED" LOAN**: the principal owed on a home mortgage is higher in the early repayment years and later, when mostly principal is being repaid. In the later years the loan amount owed decreases rapidly and so does the death benefit.
- **Increasing Term** - the face amount of insurance increases with each payment, for a specified period of time, then coverage ends. This form is rarely, if ever, sold today. It was based on the assumption that as a family man grew older his need for life insurance lessened (i.e. kids were grown and the house was paid off). Today the reality is much different for a family man in his 50's since he usually owes more than ever on his house (usually from borrowing to pay for the kid's college education whereupon his children often move back into the home after graduation).

2) Special Features Which Can Be Added to Term Contracts (Riders)

- **Renewable** - The insured has **the contractual right to renew the term policy for a similar term of time without being required to provide proof of insurability** (good health). Normally this renewal feature is restricted by age (available only to age 65, for example) or number of times renewed, or a coverage time may not be renewed at all in the case of long term coverage periods (twenty or thirty year policies, for example). The insurance company must charge no more than the **standard rate if a contract is renewed**. It is usually found in annual, five year and ten year level term contracts.
- **Convertible** - The insured, under a term life contract, owns the **right to convert/change that term policy to any Whole Life (or permanent) policy offered** for sale by the company. Universal life is considered permanent for conversion purposes. This option must be exercised no later than some specified future time as described in the contract. The conversion must be allowed, without proof of insurability, by the insurance company at standard rates.

All Three Term Varieties: level, decreasing and increasing may be purchased with one or more of the "RIDERS" discussed above. **A rider is an additional, but optional, coverage for which the policy owner will pay additional premium.** Life riders are requested and added at the point a policy is issued and they are generally not available at a later point in time after a policy has already been issued. Although the **riders** listed above **are sold with MOST term** policies that offer them, there are **NOT sold WITH ALL**. A "nonrenewable and nonconvertible term" life policy expiring in 5 years or less can be purchased for a specified short term life insurance need.

NOTE: > Policy conversions take place at "**attained**" age of the insured (this **means** the **current age** of the insured at the point conversion is elected).

C) Interest-Sensitive Life Products

All of the products described in this section have one thing in common: **they all pay a rate of return on cash value (also called policy account or account value) that fluctuates** rather than a fixed, never changing and unknown percentage paid on straight whole life contracts). Two of the products, **Universal Life and Interest-Sensitive Whole Life (ISWL)**, **guarantee cash value** to the policy owner but the insurance company reserves the right to make all investment decisions. The other two contracts, **Variable Life and Variable Universal Life**, allow the policy owner to make investment choices but some of the choices could include the loss of principal (**the investor bears the risk of loss and the insurance company makes no guarantees as to return of, or return on, principal sums in the policy account**, unless a guaranteed account has been offered by the company and selected by the policy owner).

Why would a policyowner select a product without guarantees? For a higher rate of return on principal. The Variable contract owner is seeking to earn a return that keeps pace with, or even outpaces, the inflation rate. The downside is risk to principal while the upsides are the possibility of more significant earnings and greater death benefit coverage amounts to enhance the value of money invested.

Guaranteed Products

■ Universal Life (also known as "*Flexible Premium Whole Life*")

This contract combines the best features of **low cost term insurance with a tax-deferred policy account feature** which allows cash values to build (tax-deferred) at fixed rates that fluctuate up and down with general market conditions. The term insurance **cost can be paid either by making regular premium payments or from the policy account itself**. The policy owner **can even choose to skip some payments completely** as long as there is sufficient cash value upon which the company can draw to cover term cost expenses on a continuing basis. However, if planned or target premium goals are not met over the life of the contract (including the replacement of any cash value withdrawn or borrowed) then this policy is prone to lapse at a future date and the policyowner may not enjoy coverage at older ages if the cash account runs down to zero.

The interest that accumulates in the **savings fund is taxable only** when the insured receives it **to the extent it exceeds the entire amount of cumulative premiums paid**. However, cash values may be withdrawn up to the total amount of premiums paid, without causing a taxable event. Such a **withdrawal** is just that - **it is not a policy loan** and no interest is charged if the policyowner elects this option. Since the policyowner is paying on an ongoing basis for the term cost of the product, all cash values and interest payments that are in excess of insurance cost belong to the policy owner and not to the insurance company. **Cash values, or policy accounts, are guaranteed by the insurance company** to achieve some minimal return (usually 3% to 4%).

The *advantages of Universal Life*, over traditional cash value policies, are the **greater flexibility** the owner enjoys for premium payment and with the possibility for higher yields. The owner can also request an increase in death benefit (if insurability requirements are met). Universal Life contracts also allow the *option of either a level death benefit or an increasing death benefit* (increasing means the original death benefit amount is paid plus any accumulated cash value when the insured dies).

■ Interest Sensitive Whole Life (ISWL) behaves **exactly like** a traditional **whole life** contract (review earlier section on traditional while life for more details) **except** that the **rate of return** paid on cash value principal **can fluctuate** with market conditions for fixed, conservative rates of return. This will mean ISWL will provide a higher yield during increased rate markets than will traditional whole life contract, but possibly less return in low interest rate markets (such as those experienced in the years 2002-2004). An ISWL contract has floor interest below which a rate of return will never falter. A fixed and regular premium is payable in an ISWL policy.

Products Without Guaranteed Return – The Consumer Bears All Risk of Investment Return

Both Variable products discussed below provide coverage on a term cost basis but can be used to accumulate cash value on a tax deferred basis. Similar to the structure of Universal Life, the variable contract owner can access cash accounts by withdrawal of funds as opposed to borrowing (which is an option as well) them .

■ **Variable Life** requires a **fixed and level premium payment**. However cash values (amounts invested which are more than the policy cost) can be invested in a wide range of accounts such as bond funds, money market funds, mutual funds, balanced funds, aggressive growth funds and even a guaranteed fund (which pays a fixed and usually lower amount). In the guaranteed fund, a loss to principal cannot occur to any funds placed therein.

This plan (first offered in 1976) is not considered a traditional form of life insurance. Although the **CONSUMER BEARS ALL INVESTMENT RISK**, the “upside” is not only the possibility a higher long term investment yield, but also an increasing face amount of insurance which will also keep pace (or maybe outpace) the long term rate of inflation. The **death benefit** originally purchased is **guaranteed** to be paid upon the death of the insured **regardless of investment return** so long as premiums are paid on time as they become due.

■ **Variable Universal Life** is the same as Variable Life except it offers the flexibility of Universal Life premium payment: **premiums can be paid flexibly or even skipped altogether as long as cash account value exists to pay the mortality and expenses of the policy**. It is subject to Securities and Exchange Commission (SEC) and state insurance rules as is Variable Life.

NOTE: The **attraction** consumers would have to a **variable life insurance contract** is based on the **POTENTIAL return** of the variable product and its ability to **keep pace with or even exceed the rate of inflation**, over time, in our economy. The **"downside"** of such a product is the notion that **the consumer is on his own** and any financial losses suffered to cash values are his problem. A **prospectus must be supplied** to any prospect **for a variable life insurance product and suitability requirements must be met**. The selling agent **must have a series 6 NASD security license, or higher in addition to a state life insurance license to market variable insurance products (including variable annuities)**.

D) Combination Plans and Variations

The concept behind the combination plan idea is to create products that meet specialized needs and, in the case of the two contracts that follow, combine the coverage of two (or more) lives into a single contract.

■ **Joint Life (JL)** is a life insurance contract which promises to pay the face amount of the policy based on the **death of the FIRST of two or more insureds covered** by the (SINGLE) contract. Often the contract is used to insure both a husband and wife, each being the beneficiary to the others. > **THE POLICY ONLY PAYS ON THE DEATH OF THE FIRST COVERED INSURED WHO DIES, AND THEN THE CONTRACT IS OVER.** Once death occurs to the first insured the survivor(s) then loses the coverage unless they **exercise the** contract’s right to buy permanent insurance without having to prove insurability. However, if both insureds **die in a common disaster** (see **Section II, beneficiaries** for additional explanation), the insurer will pay the full face amount for each insured.

The advantage of JL: the **premium cost** for a given face amount is **smaller** than the total premiums would be for the same two people had they bought separate policies individually. JL coverage can be found under both term and universal life plans, in addition to permanent plans.

■ **SURVIVORSHIP LIFE (SL)** are known as > **"last-to-die" or "second to die" contracts**. Two or more lives are insured under a single policy and the death benefit is **paid upon the death of the second or last insured**. Nothing is paid when the first insured dies. SL contracts can be issued as permanent term or universal insurance.

> **SL differs from joint life because SL pays on a life OTHER THAN THE FIRST TO DIE.**

SL is an attractive policy type for the **estate planning** process when the unlimited marital deduction is used. More than two lives can be insured with the death benefit paid either upon the second, third, fourth or greater life. Another advantage is that the cost is less than insuring two or more people separately.

F) ANNUITY > MAIN CONCEPT: ANNUITY IS NOT A DEATH BENEFIT.

IT IS A PERIODIC PAYMENT OF MONEY MADE TO THE "ANNUITANT" (the person who receives benefits under an annuity contract) OVER HIS OR HER EXPECTED LIFETIME, OR FOR A SPECIFIC PERIOD OF TIME.

* **Life insurance begins** payment **upon** the insured's **death**

* **Annuities** usually **STOP** payment **upon** the **death** of the annuitant (recipient).

Until the annuitant receives payment, an amount of money is, or has been, invested. This **capital (or principal) sum will earn an interest rate on a tax - deferred basis.** In return for the invested principal amount, the annuitant can receive benefit payment (**usually monthly**, quarterly, etc.) for the remainder of his or her lifetime.

1) ANNUITY RETURNS: *FIXED, VARIABLE AND EQUITY INDEX*

● **Fixed:** the insurance company bears **ALL investment risk.** The annuitant gets the same amount of **guaranteed income**, usually paid monthly, for either a specified period of time or for as long as he or she lives.

ADVANTAGE of a fixed annuity : YOU ALWAYS KNOW WHAT YOU ARE GETTING

DISADVANTAGE of a fixed annuity: YOU ALWAYS KNOW WHAT YOU ARE GETTING

(AS INFLATION INCREASES, **PURCHASING POWER IS CONTINUALLY REDUCED**, therefore, the longer the fixed annuitant lives, the worse their standard of living will become).

● **Variable:** the annuitant bears **ALL investment risk** for any principal amounts invested in securities which are not guaranteed (refer to part C, this Section for a review of variable policy discussion). The regular benefit payment can be greater, less than or the same as that which was originally projected, depending upon actual returns made by the underlying investments.

ADVANTAGE of a variable annuity: INCOME CAN KEEP PACE WITH OR EXCEED INFLATION RATES

DISADVANTAGE of a variable annuity: YOU COULD LOSE YOUR SHIRT

● **Equity Index:** the annuitant cannot experience any loss to principal but returns are based on the performances of stock indexes (such as the Dow Jones Industrial Average or the Standard & Poor's 500). Interest is credited based on a formula linked to stock indexes. The formula may result in no interest credited but **the return can never go below zero.** Since there is no risk to principal there is no securities regulation by the SEC and no securities license is required to sell these products. Usually there is also the option to place some or all principal in a fixed account, if the contract owner chooses to do so. The interest rate credited can be determined either on a month to month basis or an annual anniversary basis. **The annuity owner never has money at risk in the equity markets.**

2) ANNUITIES BENEFIT PAYMENTS - ARE PAID EITHER IMMEDIATELY OR DEFERRED TO THE FUTURE

● **SPIA:** "Single Premium **Immediate** Annuity" - pay one lump sum to an insurance company and start getting periodic checks right away for life.

● **SPDA:** "Single Premium **Deferred** Annuity" - pay one lump sum to an insurance company and wait until some future point (i.e., retirement) to begin receiving regular benefit checks for life.

● **FPDA:** "Flexible Premium **Deferred** Annuity" - save incrementally as you decide, then begin taking income at a future point on a periodic basis for life (i.e., begin at retirement).

> **NOTE:** there is **no such thing** as a “flexible premium immediate annuity.” You have to place a large single payment amount with an insurance company to enjoy an immediate annuity. If you wish to place small, flexible amounts into your annuity account periodically over time then you can only purchase a deferred annuity.

Income Taxation Concepts Relating to the Annuity

As annuity principal is invested and earns income, the **income portion earned** is not immediately taxable -- it is **tax-deferred because an annuity is a life insurance contract which enjoys this favorable tax treatment**. Income **taxes are due** and payable **on any income earned only when income is actually withdrawn in the future** by the annuitant (in other words, taxation happens only when a benefit is paid).

Any money that was placed into the annuity periodically as “**after tax**” income is considered “**principal**” and **principal is never taxed again** but is returned later to the annuitant as part of their regular benefit payments. Therefore **each future benefit payment made to the annuitant is partly income taxable** (the *income portion* that was accumulation tax-deferred) **while the balance is excluded** from taxation (that portion of each benefit that is a *return of the original principal* amount invested).

3) FACTORS AFFECTING INCOME: the actual amount of benefit paid to an annuitant depends upon these factors:

- ✓ **amount of money invested and the corresponding rate of return earned**
- ✓ **age of annuitant at withdrawal-- the older you are when you take a benefit, the higher your check will be**, all other factors being equal (because you are not expected to live as long as a younger annuitant).
- ✓ **sex of annuitant:** all other factors being equal, **men receive larger benefit payments than women** because women are expected to live longer (and are thus around longer to collect).

4) ANNUITY BENEFIT WITHDRAWAL ALTERNATIVES - Annuitants wishing to collect their money can:

- 1 Take a "lump sum" - all the money at once**, both principal and interest (**income tax is due on all income earned—the up until now tax-deferred earning amount- in the year paid at the owner’s individual income tax rate**). All principal is returned without taxation because taxes were paid before the money was placed in the annuity originally.
- 2 Annuitize** - the company will take all the money which has accumulated in the account over the accumulation period and, based on the annuitant’s age and annuity choice, will pay a regular periodic check for the duration of the payment period. **Each payment received by the annuitant is made up of both a partial return of originally invested principal and interest**. The annuitant is only responsible for paying taxes on the interest portion of the payment. (Note: the older the annuitant, the greater the return of principal in each benefit payment and therefore the less the income portion which is taxable on each benefit payment).
- 3 Combination** - take your money as a partial lump sum and annuitize the remainder.

>**EXAMPLE:** Bob has been paying into a flexible premium deferred annuity for 40 years. Currently at age 65, Bob has put \$ 400,000 into his annuity with “after tax” dollars while earning an additional \$600,000 in income on a tax deferred basis. If Bob decides to annuitize the entire \$1,000,000 he will get a periodic benefit check whereby part of the check is not taxable (the return of his premium portion) while the other part is income taxable (the portion of the benefit that is deemed to be income on which taxes were deferred during the accumulation period).

If Bob opts for a lump sum distribution instead of annuitizing the cash value, then he will have to pay income taxes (on an ordinary income basis) on \$600,000 for the tax year in which he receives the lump sum payment.

5) ANNUITY SETTLEMENT ARRANGEMENTS – These are the basic (fixed) choices the annuitant has available upon selecting annuitization:

- **LIFE ANNUITY** (sometimes referred to as "straight life annuity" or "pure annuity"). A life only annuity **provides** the annuitant with the **highest possible fixed income, guaranteed by the insurance company**, for life. Should the annuitant die from excitement upon cashing his first annuity check, this contract is over (“nice doin’ business with ya”) and the principal and income remaining is "**retained**" (“kept” is such a harsh word) by the insurance company.
- **CASH REFUND ANNUITY** leaves **all money not yet distributed** to the original annuitant **to a named beneficiary** upon the annuitant's death.
- **JOINT AND SURVIVOR ANNUITY** ties the benefit payment to **two or more lives** (i.e. husband and wife). A regular check is paid based on both annuitants being alive and, **when one dies, the survivor continues receiving income** for the remainder of their life (although it is usually a reduced amount of 1/2 or 2/3 of the original monthly amount paid for two lives).
- **PERIOD CERTAIN ANNUITY** - the annuitant receives a fixed monthly amount for life or a period certain (usually 5, 10 or 20 years is selected) **WHICHEVER IS LONGER or JUST FOR THE SPECIFIED PERIOD-(THEIR CHOICE)**. If the annuitant dies prior to the completion of the "period certain" any remainder of benefits not yet distributed on the contract is still paid to a contingent payee.

6) MISCELLANEOUS ANNUITY FACTS

- ✓ The **greater the guarantees** made by the insurance company to the annuitant, **the lower will be the regular and fixed income**. (Example: the annuitant who chooses a "life annuity" gets more money each month than he would if the "cash refund annuity" had been selected, instead.
- ✓ **Age 59 ½ is the magic age for starting an annuity benefit** from an income tax viewpoint. **Taking any money** from the cash value of an annuity **prior to age 59 ½** will subject the annuitant to **paying taxes on the income** from the annuity **PLUS A 10% TAX PENALTY**. Furthermore, according to tax law, all money which came out is treated as income earned first, and a return of principal second.
- ✓ **Once a decision to annuitize has been selected** and the first benefit check issued, **the decision cannot be undone and the annuitant is stuck with the arrangement for life**.

SECTION II)

POLICY PROVISIONS AND OPTIONS, RIDERS AND EXCLUSIONS

(21 QUESTIONS - 42% OF TEST)

A) Policy Provisions and Options (M=Mandatory-must be in the life contract)

■ **Entire Contract (M)** is a clause which states that the **policy AND the application** (a copy of which is attached to the policy) are the **entire agreement** between the insurance company and the policyholder. It also states that as long as there is no fraud, **all statements** made by the policyholder **are** deemed to be **representations** and **not warranties**.

> A **WARRANTY** is considered, by its maker, to be an absolutely true statement. If a warranty is made and a later falsehood or contradiction is uncovered, **the contract can be voided, even if the warranty was in reference to a minor and immaterial point**. A warranty only exists where actual fraud is involved. No statements made for a life and health contract are considered to be warranties.

> A **REPRESENTATION** is a statement made which is considered **true** (in the opinion and to the knowledge of the individual making it) **but whose later contradiction would not void the contract**. As a matter of statutory law (in all states) all statements made by an applicant for life and health insurance policies are deemed to be representations and not warranties. In order **to void a contract, the company must show ALL five conditions as set forth below**:

- ① the **representation was material** (goes to "the heart" of the agreement, which means that had the company known the truth, it never would have issued the policy as it did); **AND**
- ② the **representation was false**; **AND**
- ③ the **insured both knew the representation was false and made the statement "recklessly** without any regard for truth"; **AND**
- ④ **it was the insured's intention for the company to act upon the falsehood**; **AND**
- ⑤ the **company did act upon the false/material representation**

■ **Insuring Clause - the promises between the parties are found in this clause**. The promise is that in return for regular stated premiums paid by the owner in a timely fashion to the company, a stated amount of insurance proceeds will be paid in the event of the insured's death. Upon proof of death, the proceeds will be paid to a designated beneficiary or to the insured's estate if no beneficiary was named.

The **parties named** or referred to in the insuring **clause include: the policyholder, the insured, the company and the beneficiary(s)**. The amount and type of policy is included in this clause.

For test purposes: "**mode of premium**" is **NOT INCLUDED in this clause and has its own clause**.

■ **Free Look/Free Examination (10, 20 or 30 days)** clause says that once a policy has been **delivered (delivery date is key as the test concept) to an owner**, the owner has a specified period of time to decide whether or not to keep the insurance. At any time during "Free Look" the **owner may return the policy** to the company for a **full refund** of premium paid.

■ **Consideration Clause** states that the life insurance coverage is in effect upon payment of the premium which is due in a timely fashion. The **only duty** placed on the **policy owner** is to **pay the premium** on time.

> **The first premium** due, when **submitted with the application, constitutes "initial premium."**

> **Initial consideration** therefore equals two factors:

- ① the **statements made** in the application (representations must not be material misrepresentations) **plus**
- ② the **money collected** at the time of application (payment must be good. i.e. not a bounced check).

■ **Owner's Rights (M)** – this clause sets forth the contractual rights belonging to the policyowner (the "Applicant"). Rights include >assignment (transfer of some or all rights held to another party – owning a life contract even entitles the owner to sell or gift his ownership to another party without the permission of the insurance company), >beneficiary changes, >borrowing against any existing cash value, >surrendering the contract for all existing cash value, >selection of mode of premium (as well as the right to change mode at any time) and to decide how to take >dividends if the policy was purchased from a participating insurance company.

In the event the **insured and the policy applicant are different parties** (i.e. buy & sell situation in which two business partners own a policy on each other) the **owner (applicant)** has all of the rights mentioned above and the insured (who is not the owner) has none (the insured is merely the insured and nothing more).

Modes of Premium Payment or **frequency of payment** is selected by the owner. The modes available include:

- ◆ ANNUAL (1 a year), ◆ SEMIANNUAL (2 a year),
- ◆ QUARTERLY (4 a year) and ◆ MONTHLY (12 a year).

Since overhead to an insurance company is lower for less frequent premium payment modes, the annual mode (which is the least expensive of the four modes available) provides a discount versus semiannual and semiannual is less expensive quarterly and quarterly is more costly than monthly. Automatic monthly check withdrawal of premiums has changed this somewhat but annual is still less expensive as a rule than monthly automatic deductions.

NOTE: The **owner** of the policy has the **right to select a new payment mode AT ANY TIME** after policy issuance, (i.e., there is NO restriction that the owner must wait for a policy anniversary date to effect a mode change). A change can be made effective with a **simple request** by the owner for the **mode change** made to the company.

■ Beneficiary Designations

are made by the applicant (who will be the owner of the policy). The beneficiary will receive the insurance proceeds in the event of the insured's death. *Proceeds are what the death benefit is called technically upon the death of the insured.*

• **Primary versus Contingent:** the primary beneficiary is named to receive ALL proceeds as the **first choice** of the applicant. An applicant can name more than one person as a primary beneficiary but must indicate on the application what percentage of the proceeds each beneficiary will receive. The **contingent** beneficiary is a **second choice** and **only collects in the event the primary beneficiary dies before the insured.**

When listing people as beneficiaries be aware of the difference between **NAME versus CLASS** designations **Name designation** is writing the **actual legal name** of the person as the beneficiary while a **class designation** means people or a person who fit into a **relationship description** of the applicant (i.e. spouse, children, brothers, sisters, etc.)

If you put the name of your wife as the beneficiary and then get divorced and remarried to someone else but never change the name of your first wife as the original beneficiary then the first wife (not the current spouse) would be the beneficiary. Likewise, if you put "all my children" as beneficiaries this would include ALL your children including any born out of wedlock. As you can see, naming the beneficiary is a bit more complicated than it seems at first glance and some deeper thought may be required, depending upon the applicant's personal situation.

• **"Revocable" vs. "Irrevocable."** Most beneficiary designations are **"revocable," meaning the owner may change a beneficiary at any time** by properly notifying the insurance company (in writing).

However, if the owner chooses to name an **"irrevocable"** beneficiary (or is forced to by a judge, as is the case commonly with divorce settlements), the **owner of the policy has waived (given up) any right to change the beneficiary** without first getting the approval of the named irrevocable beneficiary. Other rights in the policy which are affected when an irrevocable beneficiary designation exists are the ability to borrow against cash value or to cash surrender a policy. Either would require the permission of the irrevocable beneficiary.

- **Change of Beneficiary language in the policy** entitles the policyowner to change a revocable beneficiary at any time. **Changes must be requested by the owner (*must be authenticated in writing*)** and the insurance company must acknowledge any change in writing by "**endorsement**" (**an endorsement means a change was made to an insurance policy after the original point of policy issuance**). The insurance company will then send a written acknowledgement to the policyowner who should then attach the form to the original policy. The policy owner has no obligation to inform a revocable beneficiary that he/she is no longer a beneficiary.

- **COMMON DISASTER**: In this ultimate "what if" scenario the insured and beneficiary die together in a common disaster and there is no way to know who died first. To collect, the beneficiary must clearly survive the insured, usually by at least 30 days. Otherwise, the courts apply the **Uniform Simultaneous Death Act** which requires that, in cases of common disaster and death, the **POLICY PROCEEDS ARE DISTRIBUTED AS IF THE INSURED SURVIVED THE BENEFICIARY**. Without a named contingent beneficiary, the proceeds would be paid into the estate of the insured and would be subject to probate.

- **MINOR BENEFICIARIES**: Insurance carriers will not pay proceeds directly to a minor beneficiary under the legal theory that minors are not competent to receive payments of death benefits. If the insured dies and the legitimate beneficiary is a child under the age of majority (usually eighteen years of age) then **the insurance company will leave the money with the probate court** in the county and state of the deceased insured. This means that the proceeds, which could have been paid outside of probate, will now be subject to the probate process. It also means that the Probate Court will have to approve any money released for the care of the minor who was the intended beneficiary of the proceeds.

It is not a recommended practice to list minor beneficiaries as either primary or contingent beneficiaries on a life insurance application. The best course of action is to place ownership of a life policy in a Living Trust when proceeds are directly or indirectly intended for a beneficiary who is not of legal age.

- **Grace Period (M)** is a **31 day time allotment** the owner has **from the premium due date** in which to make the premium payment without losing some essential rights granted in the contract. **If the insured dies during the grace period, the death benefit is paid and any unpaid premium due is subtracted from the proceeds paid.**

The **grace period** is the provision which must be **examined before all others in the event premium payment is less than 31 days late**. If the **31 day grace period expires without payment**, then the **policy is "lapsed"** and the **"reinstatement clause"** (if there is cash value) controls to determine the contractual rights between the parties. If a term policy has lapsed then the contract is over and the insured must apply again for a new policy

- **Automatic Premium Loan (APL)** is a grace period related concept. **APL is NOT A MANDATORY CLAUSE**, which means the opportunity is **offered by some, BUT NOT ALL** insurance companies. The APL clause provides that if a premium payment is not made by the end of the grace period, the insurance **company is authorized to automatically take enough cash value, on a loan basis, from the existing policy account to avoid a policy lapse**. APL can be a rider, requested in writing by the owner or sometimes it may be elected at the time of application. If there is no cash or not enough cash in the policy account to cover the premium, then the policy would lapse.

>NOTE: Obviously, APL is not available in life contracts **which do not have cash values (i.e. term life)**.

- **Reinstatement (M)** - allows the owner **a period of time** (from between 3 to 5 years, depending upon state law), **from lapse AND** while the policy is **on extended coverage** and not surrendered or canceled, to repay all back premiums due (refer to "nonforfeiture" options: extended term insurance" located below for details on this AUTOMATIC nonforfeiture option). Once reinstated, a policy will be **put back in force** again and will date back **to the original issue date**. **Please note that term contracts have no cash value and reinstatement is not offered in term policies.**

Under this provision, the **insurance company can require >evidence of insurability and >repayment of all premiums owed >PLUS interest (as well as repayment of any other debt, i.e. policy loans)**.

- **Policy Loans and Withdrawal (M)** - allows the owner to access amounts that do not exceed the cash value.

In a ***POLICY LOAN PROVISION***, the contract stipulates the interest rate to be charged for any loan made. There is **no obligation to make any repayment** of the loan, but if the loan and interest charged on the loan equals the cash value, the policy is no longer in force. If the **insured dies** with an existing outstanding policy loan, the **policy loan amount is deducted plus interest from the proceeds paid**. The policy owner is required to pay interest on amounts borrowed because the cash values are technically “owned” by the insurance company until the policy owner cashes out, dies or makes it to age 100. (This language is found in traditional whole life contracts not term policies)

In a ***WITHDRAWAL*** situation, found in universal and variable life contracts, the policy owner may access policy account values by paying a one time minimal service charge. This is no interest due or payable since the owner is taking his or her “own money” which is in excess of the insurance costs already paid.

The effect of the loan or withdrawal is to create an **advance against the future death benefit payable** in the event the withdrawn or borrowed funds are not replaced before the death of the insured. There is no obligation to repay principal, interest or withdrawn funds while the insured is still alive but failing to repay any amounts could result in a policy lapse prior to death.

- **Nonforfeiture Options (M) found in cash value plans –**

These **THREE** options are ***important when the policy owner does not pay the required premium*** because he or she no longer wishes to keep the original permanent (cash value building) plan as purchased. These options apply only to contracts which build cash values and are not offered in term life contracts. The **first and third options must be elected by the policyowner** while the second option (**extended term insurance**) is **AUTOMATIC** when the owner lapses the policy and fails to notify the insurer of an election of any other nonforfeiture option which was available.

THE THREE Nonforfeiture OPTIONS ARE:

① **Cash Value (SURRENDER)** is paid to the owner who **surrenders the policy** and all rights otherwise held by the policy owner. The amount of CSV (“cash surrender value”) is calculated from tables which are included in the life insurance contract. Once the contract is surrendered, death benefit coverage no longer exists and the contract is terminated.

② **Extended Term insurance** is the only “automatic” selection of the three options offered. ***In the event the policy owner stops paying premium but neither cash surrenders nor requests a reduced paid up policy, the insurance company automatically places the policy on extended term coverage*** (at the original amount of death benefit purchased). The full face **coverage by the company** continues for as long a time period as cash value in the policy remains to make required payments at the term life rate for the insured at his or her attained age. If the insured dies at any time during extended coverage, the full face amount is paid to the beneficiary. ***Before a contract can be eligible for reinstatement, it must be on extended term insurance and must not have been surrendered or had the paid-up option exercised.***

③ **(Reduced) Paid-Up Insurance** allows the owner to use the entire existing cash value to purchase a fully paid-up face amount of insurance of the same type originally purchased. This “reduced” face amount is less than the original amount, but no further premium payments are required. This is the **only nonforfeiture option** by which **cash value continues to accumulate** (until the endowment point of the policy, i.e., age 100 for whole life contracts). Otherwise, reduced face amount is paid when the insured dies. The owner can borrow against existing cash values. Practically speaking the policy owner is taking the existing cash value and asking the company to issue a Single Premium Whole Life Policy (with a face amount that is reduced from the amount originally purchased).

■ **DIVIDENDS AND DIVIDEND OPTIONS** - are available to owners of “participating” plans (offered only by “Mutual” insurance companies, and not by “Stock” insurance companies). Mutual policy **dividends** are declared annually (and paid at the end of a policy year) by the company and **are not considered, by the Internal Revenue Service, to be either profit or income and are therefore not taxable**. Instead, they are treated as overcharged premium which is being returned. When offered, dividends must be paid on an annual basis to policyowners.

The most common dividend options offered by an insurance company to a policy owner are:

- **Cash**

- **Accumulation at Interest** - (Commonly found in older policies) means the dividend is invested with the insurance company to earn interest at a rate of interest specified in the policy. While dividends are not income taxable, all **interest earned upon dividends** is income and taxable. As the dividends and interest accumulate, they are compounded and are available to the policy owner at any time. If they are not cashed-in by the policy owner, then dividends and accumulated interest amounts are paid in addition to the face amount of the policy in the event of death to the insured.

- **Paid-Up Additions** (Commonly found in older policies) apply the dividends to purchase additional amounts of (all paid up) death benefit. Essentially, it is a “mini” single premium death benefit purchase. Whatever additional insurance the dividend amounts purchases (always at the insured’s “attained age”) is added to the original policy face amount. Again, the owner may take the dividend in cash at any time and thus eliminate any additional paid-up insurance that may have been purchased.

- **One-Year Term Option** - uses the annual dividend to purchase one year of term insurance coverage at the insured’s attained age, which would be paid in addition to the face amount of the contract if the insured dies in that year. If this option is selected at a time later than original issue, the company may require evidence of insurability. Most companies do not offer this option, but a few still do.

The following three dividend choices are the three that are used most often in the insurance industry today:

- **Premium Application** - simply applies the cash dividend due as a credit against the very next premium charge, thus lowering the premium cost.

- **Endow the Policy** - uses the dividend to pay the insurance faster by adding it to the tax-deferred cash value accumulation, thereby creating a closer endowment date.

- **Paid-Up Option** - means the dividend is added to the cash value of the policy to create a fully paid-up policy prior to the time full payment would otherwise have been made. It is **used** in the insurance industry **to “vanish”** future premium payments. When the dividend plus interest and cash value equal the net single premium due at the insured’s attained age, the policy can be endorsed as fully paid, but it will not mature until the original endowment point.

NOTE: Two other **TEST CONCEPTS** to understand about dividends:

❶ The **main benefit** of a participating policy dividend is: **insurance cost is reduced**.

❷ **Policy loans taken will not reduce future dividend payments** as long as regular (future) premiums are paid on time.

■ **Incontestability (Clause) (M)** is a **two year period** of time **from policy issue date** (the *issue date* is key) that an insurance company has to investigate applicant statements made in the application of insurance **to determine whether any error, misstatement, fraud or concealment was perpetrated in order to induce the company to issue the policy**. The incontestable clause protects the policy owner and beneficiaries because it prevents a company from not paying benefits after two years due to any material misstatement, concealments and most fraud. **The burden is clearly upon the company to uncover material misrepresentations, fraud and concealment information during the first two policy years**. If the company cannot or does uncover material misrepresentations, *then in most cases the policy cannot be contested by the company after two years and the death benefit must be paid.*

■ **Assignment** is the transfer of some or all rights held under the insurance contract by the contract owner (assignor) to another party or individual (the assignee). A life insurance contract is an intangible personal property right owned by the policyowner who can freely sell, transfer or assign that ownership to any other party. The two common types of assignment of life insurance contracts are:

- **Absolute** – this means "all incidents of ownership" are transferred to the assignee who now stands in the same position as did the assignor who transferred the rights (the first owner assigns the policy ownership to a new owner).

- **Collateral** - is where the life contract (cash values and/or death benefit) are used to secure a transaction (i.e. loan) between the policy owner and the assignee (usually a bank or some other creditor). This is not an absolute assignment because the policy owner only assigns those rights incidental to securing a transaction while still retaining some other rights of ownership (i.e. the power to change the beneficiary still rests with the assignor).

■ **Suicide Clause**, for test purposes, is a **two year period from the policy issue date** (*issue date* is key) permitting a company not to pay a death benefit if the cause of death is suicide. **Liability to the company** during this "temporary exclusion" is **limited to premiums paid without interest (premiums paid are refunded to the beneficiary)**. Accidental death is never considered suicide and is therefore covered (unless it can be proven the "accident" was actually a suicide).

■ **Misstatement of Age and Gender**. Accurate age and gender information is important because it has a bearing on premium cost. However, **misstatements in these two areas will not void a policy (IT IS NOT CONSIDERED A MATERIAL MISSTATEMENT OR FRAUD)**. Once the inaccurate information is discovered, it is corrected by calculating the premium *payment that should have been collected* based upon correct age (or sex) of the insured from the inception of the policy. **If the error is found at the time of death, the > death benefit is adjusted** up or down to the amount it should be, had proper premiums been paid from the time policy issuance.

■ **Settlement Options (M) - Lump sum payment of the face** amount of a policy to a beneficiary is just one of many possible payment options (although it is the most common). The insurance contract allows the settlement options described below (available to the policy owner, before death, or to beneficiary, after the insured's death, assuming the policy owner did not already prescribe the method of settlement which is then forced upon the beneficiary). **Most of the available options are forms of annuity payments:**

- **Interest Only**. The **company retains the proceeds and pays interest at a minimum stated rate** (or higher, if earnings increase) to the beneficiary. The policy owner may also direct that none, some, or all principal will be paid out to the beneficiary (or to a contingent beneficiary) upon the death of the primary beneficiary.

- **Fixed Amount Option**. A fixed periodic payment (monthly, quarterly, semi-annual or annual) is to be paid until the principal and interest both run out. Therefore, the dollar amount is fixed, but the number of payments is not (since it depends on principal and interest available).

- **Fixed Period Option.** Very similar to an annuity certain where **equal installments are paid for a specified time period and then stop.** The installments may continue past the life of the primary beneficiary and would be paid as designated by contract.

- **Life Income.** The **proceeds are held by the company and regular periodic payments are made to the beneficiary for as long as he may live.** If the beneficiary dies, even if only one benefit payment had been made, payments by the insurance company stop. It is possible to combine life income with the fixed income option for a hybrid known as "period certain and life thereafter." The longer the period certain chosen, the smaller the installment payment.

- **Joint and Survivor.** Proceeds are paid in installments during the lifetime of two or more beneficiaries. A full benefit is made to all beneficiaries while alive followed by a reduced percentage (50%, 66% or 75%) to a survivor.

NOTE: Please bear in mind that most insurance companies will make any special settlement arrangements as long as they are legally and financially sound.

B) Policy Riders

- **Guaranteed Insurability Option (GIO)** is designed to allow **young people the right to make additional future insurance purchases without regard to future evidence of insurability.** A specified amount may be purchased at contractual points in time, usually every three years from age 25 to 40. **Certain** results or **occurrences** also **allow** the insured to **"pick up" a future age** before the actual point in time occurs (i.e. if the insured gets **married, has a child or adopts children**). The extra premium paid only entitles the owner the right to buy more coverage. However, if the owner fails to exercise one or more options, they are forever lost. Due to the availability of inexpensive term, the GIO is not widely used today.

- **Waiver of Premium and Waiver Of Premium With Disability Income**

- **Waiver of Premium** is a rider whereby premium payments are **"waived (do not have to be paid)" for as long as the insured has a disability which is "total and permanent"** in nature. There must be **six continuous months of permanent and total disability** (known as the "waiting period") on completion of which the **company will refund any premium paid for the first six months and continue to waive all upcoming premium due** for the duration of the disability up to the benefit expiration age (usually age 60, 62 or 65). **The definition of "Total"** disability varies, but means unable to work (generally) to the less restrictive unable to perform the functions of the insured's own job. Disability must occur prior to age 60 or 65 to activate this rider.

TEST IDEA: If the insured was disabled for one year, for how many months would premium be waived?
The correct answer is 12 months (the second six months were waived and the first six months reimbursed).

- **Waiver Of Premium With Disability Income (DI)** is a more recent industry rider (which can be used on Universal and Variable life contracts) whereby the **carrier waives the cost of premium and expenses** for the life insurance coverage **while also paying a monthly income**, due to disability, to the insured. Typically any disability income benefit under this rider is payable either for two or five years and **each would have an elimination period** (a waiting period that begins with disability and runs for a specified length of time before a benefit is paid) is met. The elimination period is usually three months for a two year DI benefit and six months for a five year DI benefit.

The definition of "Total" disability varies, but means unable to work (generally) to the less restrictive unable to perform the functions of the insured's own job. Disability must occur prior to age 60 or 65 to activate this rider.

- **Payor Benefit (Juvenile Policies)** is another form of **premium waiver.** The Payor Benefit rider is added to a juvenile policy and the cost is based on the age and health of the parent or guardian who is the policy applicant. The rider states that premiums **will be waived until the insured (a child) reaches a certain age** (usually 21 - 25) **in the event** the premium **"payor"** (parent/applicant) **dies or becomes disabled** before the insured reaches the specified adult age.

- The "**Jumping Juvenile**" policy is a related concept. Many juvenile policies are written with a face amount of coverage which remains fixed at one amount while the insured is a child and then, **upon attaining adult age, the face amount of the policy "jumps" to a higher amount (usually 5 times the original face amount)**. At this time the insured can either reject the policy or he must pay premiums on the increased amount based on attained age. This provides children with the option of greater coverage later, without proof of insurability required

- **Accidental Death Benefit (ADB)** – (also known as "**double indemnity**") is written as a rider to other coverage. ADB will pay a face amount that matches the basic life policy upon which it is added as a rider if the cause of death is accidental. "**Accident**" is the key word - no benefit payment of any kind is made under the terms of this rider unless the loss of life is the result of an accident as defined in the policy. For example if the insured has a \$100,000 term policy with ADB and dies in an accident, the death benefit payable to the beneficiary is \$200,000 (or double the face amount)..

ADB is usually purchased as a rider to a life policy but it is also available for purchase as an individual contract with accidental dismemberment benefits. Scheduled dismemberment benefits are paid for the accidental loss of hand, feet, arms, legs, sight and hearing. Some companies offer free ADB in the amount of 50% coverage on the underlying contract.

According to the terms of the contract, death has to occur within 90 days from an injury, otherwise the death is not considered to be the result of the accident.

■ Term Riders

- **Other Insureds:** This refers to the use of term insurance, not as a single stand alone policy but as a rider to the coverage of another person. Typically an entire family can have life insurance coverage under a single policy. For example the wage earner is the primary insured and the spouse is added for coverage as an "other insured" by rider. Any children of the family can be added usually through the use of a "child rider." Underwriting is then done on each "other insured" person in addition to the primary insured. Other insureds must be added at the time of application and will not be considered after the policy is issued. Sometimes a non-family member can be added as an other insured (as in the case of co-owners of a business venture).

- **Conversion Options (individual policies)** In addition to the conversion privilege afforded under some term life and group contracts, there are options available offered under permanent plans as well. The insured **may exchange one permanent policy for another**, without proof of **insurability**, if there is **no additional risk** to the company (i.e. the policy owner wants to pay more premiums to switch from a whole life to a 20 pay at the same death benefit). On the other hand, if the insured wishes to make a switch that **increases the risk to the company, evidence of insurability can be required** (i.e. change from 20 pay to whole life with a lesser premium for the same face amount will increase the risk to the company because they are receiving less income for the same coverage amount.)

- **Cost of Living** - some carriers will allow a cost of living rider whereby the **death benefit amount will increase annually based on the indexed U.S Government published inflation rate**. This increase in coverage is not subject to an insurability requirement but is instead automatic and requires extra premium (on the same cost basis as charged by the policy) be paid to reflect the increased coverage amount.

C) Policy Exclusions

An "exclusion" limits the scope of a benefit which is otherwise payable. *Without the concept of policy exclusions, insurance companies would be forced to pay death claims regardless of the cause of death.* Such a situation would be undesirable because of the existence of certain high risks which are actuarially unsound to include in coverage. Historically, there have been two basic life contract exclusions: War and Aviation.

■ **War** - Death resulting from war or acts of war, whether declared or undeclared is not covered. All premium paid is refunded **plus interest**. There are two basic War clauses

- **"Status" clause is very restrictive** and states that no benefit will be paid if the insured was in the military at the time of death, no matter what was the actual cause of death.

- **"Results" war exclusion is less restrictive** and it stipulates the death benefit will **not paid be paid if the death is war related**. Therefore, death while in the military which is not war related is covered.

■ **Aviation** - Historically, there was exclusion of all aviation related death except those to fare-paying passengers on regularly scheduled commercial airline flights. Today, most policies pay for aviation loss, but extra premium might be due for private pilots and those learning to fly. Military aviation is still a strong exclusion, but even here extra premium can eliminate the restriction.

NOTE

After the underwriting process, the **insurer can add any specific exclusion** relating to an individual applicant (which can include death by dangerous hobbies, activities or lifestyles identified by the applicant in the application). (I.e. the applicant regularly skydives and the insurer issues a policy but excludes from coverage death as the result of skydiving).

SECTION III)

COMPLETING THE APPLICATION, UNDERWRITING AND DELIVERING THE POLICY (12 QUESTIONS- 24% OF TEST)

A) Completing the application

■ **Required Signatures** - The application must be signed by two, perhaps three parties:

① **the authorized producer (agent) who is taking the application on behalf of an insurance company**

② **by the applicant** - this is the party who will own the policy . For instance, in the case of a minor, the applicant is a parent or legal guardian.

③ **When the Insured is Not the Applicant** - Sometimes the insured will not be the owner of the contract, even though the policy is written on his or her life. However, *when the insured is not the applicant, the insured's signature is still required in the application*. This requirement is designed to protect the insured and it lets the insurance company know that the insured not only recognizes a third party owns a policy on their life but that he also approves of the transaction (this helps establish insurable interest for policy ownership in a third party to exist).

■ **Changes in the Application** - The application should always be completed in the presence of the applicant and the applicant should review all recorded information prior to signing the document. Occasionally mistakes are made in completing the application and an earlier response must be corrected. Any later changes (i.e. deletions, additions or corrections) **must be initialed by all parties who originally signed the application**.

■ **Consequences of Incomplete Applications** - Completing the application for insurance in a full and accurate manner is essential. It is the duty of the insurance producer to take great care in completing the application because it is the main information the company uses in the determination of whether or not to offer coverage. **The most serious aspect of submitting an incomplete application is the potential delay involved in issuance of the life contract**. Covering the lives of people is an enormous responsibility and delays due to incomplete applications can put the company (and producer) in a difficult position with respect to potential liability if the insured's health condition substantially changes during the delayed period.

■ **Warranties and Representations**

• **Warranties** are statements or conditions that the applicant for insurance represents to be **absolutely true**. The application becomes a part of the policy when attached thereto and any material misrepresentation, concealment or fraud can lead to voiding the insurance contract. False warranties, therefore, would preclude recovery of benefits in the event of loss. However, **under modern insurance law, statements made by applicants in the negotiation process are deemed to be representations and are NOT considered to be warranties**.

• **Representations** are written or oral statements made by the applicant during negotiation for an insurance policy. The maker of a representation is saying "my statement is true to the best of my knowledge and belief." When a statement is false, it is a "**misrepresentation**" and it may lead to voiding coverage **ONLY IF the misrepresentation deals with a MATERIAL FACT** (a fact so crucial that had the company known it originally, the application would have either been rejected or offered in a substantially different manner. Consequently, minor facts and information, if misrepresented, will not allow the insurance company the ability to void or rescind the contract.

■ Collecting the Initial Premium and Issuing the Receipt

At the conclusion of completing the application, it is customary for the initial (first) premium to be paid. **Initial payment is necessary before coverage can go into effect.** It is the responsibility of the agent to issue a receipt to the applicant upon receiving initial premium. *There are three possible application and/or receipt scenarios:*

- **The Effect of the Application with Money** - It is common practice in the insurance industry to take an initial payment at the time of application. The key question when money is taken with an application is: "**When does coverage begin?**" Since policy issuance is strictly within the control of an insurance company, the most generic answer is "**When the company says so!**"

The receipt most commonly issued in this circumstance is called a "**Conditional Receipt**". *This means if the applicant has complied with all that was requested of him and has not supplied any material misrepresentations, then coverage may become effective at the point the application is signed and the initial premium tendered.*

- **Unconditional Receipt ("Binder")** - this is a much **stronger receipt and indication that coverage goes into effect immediately.** The practice of issuing binders is not common among life companies, but many courts favor interpreting conditional receipts as binders in disputes brought before it as to when coverage actually begins.

- **The Effect of the Application Without Money** - When **no initial payment is made at the time of application,** there can be no insurance coverage at that point. Coverage only goes into **effect when the policy is then**

- ◆ **Delivered AND**

- ◆ **The first premium payment is made AND**

- ◆ **The applicant has signed a statement** attesting to the fact that **their health has not changed** since the time at which the original application was completed.

- ◆ The **MAIN CONCEPT:** since **no money was taken** with an application, both elements of initial consideration (signed statements in the application and the first premium) are not present, therefore **no contract yet exists.**

- **Replacement** – all applications ask whether or not the policy being applied for is intended to replace an already existing, individual life contract on the insured. *If replacement is involved then the producer has a legal duty to inform the applicant that the proposed replacement may or may not be in the best interests of the customer and that they should check out all the facts before deciding.* There is further requirement for the producer to complete an **appropriate form** regarding replacement which identifies policies being replaced that is **signed by the producer and the insured.** This **form must be forwarded with the application** to the insurance company. The insurance company must by law then notify the other company(s) of the possible replacement.

■ Disclosures at point of Sale (i.e. HIPPA and HIV)

Increased confidentiality concerns have led to federal **regulation designed to protect the privacy of individuals concerning their personal medical information and records.** As part of the life insurance application process the producer has additional forms to be signed by the applicant relating to their medical privacy rights. These forms limit the use to which an insurance carrier can put an applicant's personal medical information as well as to whom such medical information may or may not be shared (with other parties).

- **HIPPA** - under the **HEALTH INSURANCE PORTABILITY AND ACCOUNTABILITY ACT OF 1996,** insurance carriers must disclose to applicants that that all personal medicals are available to the carrier with the written permission of the insured. **This notification from allows the release of private medical information between health providers and the insurance company to assist in the underwriting process.** The authorization for medical records remains in force for 36 months unless revoked in writing sooner by the applicant. The sign permission form also defines and limits the use of the personal medical information of the applicant to the insurance underwriting function with that particular company.

• **HIV** -a **notice and consent form** relating to AIDS testing and the AIDS virus must also be provided to and signed by the insurance applicant as part of the life application process. The form lets the applicant know that any blood or urine sample collected by the insurer may be checked for HIV and that any evidence of HIV can be used adversely (against) to the pending application. The form further *allows the company to inform the MIB* (Medical Information Bureau) *and the personal physician of the applicant* about the positive presence of HIV in the collected and tested samples. Positive **results cannot be disclosed to agents or brokers** (insurance producers).

B) Underwriting

This is the process by which the insurance company, by reviewing background information of the applicant and medical history (and even medical exams), decides whether or not to offer a policy and if a policy is offered the underwriter decides the rating classification used for premium cost. **Underwriting is the right of the company and is usually conducted at the home office of the company.** Agents have no authority to issue coverage while in the field.

■ **Insurable Interest** -Each person has an "**unlimited**" insurable interest in their **own life** and may apply for and own coverage on their own life. However, **when the applicant is someone other than the insured** (third party ownership is involved), that applicant must have a direct and identifiable interest in the insured. Reason for third party ownership may include an immediate blood relationship (i.e., husband/wife, parent/child) or an economic dependence (financial loss potential due to the insured's death, i.e. co-ownership of a business or the insured owed the applicant money). Underwriters will also look for a relationship to exist between the insured and the beneficiary.

The core of the concept is that insurable interest exists if you are protected by the insurance but would not enjoy a windfall as the result of the death of the insured. Gambling, or **hoping the insured dies so you can** experience gain or **profit, mean you do not have insurable interest.** If policies could be owned by third parties who had no financial stake in the life of the insured the potential for murder or foul play for profit would be greatly increased.

■ **Medical Information and Consumer Reports** - **The most common third party sources (a party other than the applicant or insurance company)** include using **Attending Physician Statement (APS)** (a short set of questions is sent to the insured's personal physician for the doctor's opinion regarding overall insurability) and the **Medical Information Bureau (MIB)**. The MIB is a central database supported by member insurance companies through which information about previous insurance applications are stored and checked against current application information. A third source of collaborative medical information would be original and copied medical or hospital reports from previously treated conditions. In some cases (usually larger face or premium amount cases) an insurance carrier may order an "**inspection report**" which is a consumer report relating a proposed insured's lifestyle, occupation, and economic standing. An inspection report is considered an investigative consumer report, as defined by the Fair Credit Reporting Act.

KEY POINT>: In the event **information from a third party source adversely affects** the applicant's ability to secure a **standard insurance** contract, the law says **the applicant is entitled to discover the source of the adverse information.** Applicants may then dispute incorrect data and ask that appropriate corrections be made and new reports issued or, in the alternative, a written response may state an opposing position in writing for the record.

■ **Fair Credit Reporting Act** - This federal **regulation is designed to protect credit and insurance applicants** with respect to information obtained about the applicant **from third-party sources.** Since the applicant gives written authorization in the application for the insurance company to corroborate statements made, credit reports are often requested by insurance companies. The main reason is the company does not want to go through the expense of issuing coverage if someone is not likely to keep the coverage or be able to make payments.

If information on a credit report adversely affects the applicant's chances of being offered a contract, then the applicant is entitled to a free copy of the credit report used and > the ORIGINAL CREDIT REPORTING AGENCY must supply the free copy.

■ **Risk Classification** - If issued by an insurance company, a policy will have premium cost based on one of the following classifications :

- **"Standard Issue "** means a policy is issued at normal rates for the applicant's attained age and without any restrictions. This person is expected to live a normal life span according to current mortality tables
 - **"Preferred-Risk"** means having a mortality experience which is expected to be lower than average and to whom the company will offer a cost which is lower than the standard charge. Eligibility is usually based on the fact the applicant is in excellent health, is within normal height and weight requirements and does not smoke or use tobacco products. An acceptable family health history is usually also required to qualify for this lower rate. If an applicant has had either parent or a sibling die before age 60 due to cancer, stroke or coronary causes, then the applicant will not qualify for a preferred rate.
 - **"Substandard Risk"** means the applicant will be charged an additional premium (a surcharge over the standard issue rate) because he is in a higher risk category (can be based on health and/or occupational factors) Substandard rating can be as minimal as 20% greater than standard or as high as 500% (five times) the normal standard rate. Anytime an applicant is quoted a rate lower than the one actually offered by the company after underwriting it is the duty of the producer to notify the applicant of this higher offer (actually a counteroffer by the insurance company rate no later than policy delivery.
- > **"Uninsurable"** - is the label given to people who are such poor risks that they can not obtain any coverage at any cost. Normally individuals considered uninsurable are terminally ill.

■ Do Not Call List

The **Federal Trade Commission (FTC)** launched the National Do Not Call Registry **to give Americans a choice about getting telemarketing calls at home.** Producers must not contact by phone any number that is listed on this registry. The registry applies also to cell phones but not businesses. Political and charitable organizations and those conducting legitimate phone surveying are exempt from the requirements of the Do Not Call List. Also exempt are companies with which you have an existing business relationship, or those to whom you've provided express agreement in writing to receive their calls. If you are an existing customer you may be contacted up to 18 months from your last purchase with them unless you ask the company not to call again.

An established business relationship with a company also will be created if you make an inquiry to the company, or submit an application to it. This kind of established business relationship exists for three months after the inquiry or application. During this time, the company can call you. If you make a specific request to that company not to call you, however, then the company may not call you, even if you have an established business relationship with that company. A phone ***number stays registered for five years and anyone violating this registry will pay hefty fines*** (thousands of dollars) for each violation. More importantly (at least to the life insurance company you may be working with) your life carrier may also be subject to fines when you call on their behalf.

C) Delivering and Explaining the Policy

■ Explaining The Policy (provisions, riders, exclusions and ratings)

It is good business practice for the policy, upon issuance, to be personally delivered to the insured by the producer who took the application. The policy delivery session should include a basic review of the coverage purchased, options and contract provisions that will be useful to the insured and an explanation of exclusions or any surcharges which might apply to the applicant. Any questions can be answered, errors corrected and minor changes made without major inconveniences.

Personal delivery (also called "**Actual Delivery**") is the perfect opportunity to see if the client has additional insurance needs which may require satisfaction and to procure referrals. The opposite of personal delivery is called "**Constructive Delivery**" (the policy is delivered via mail, UPS, messenger, etc.).

■ **When Coverage Begins** -At delivery the producer should inform the owner as to when coverage begins. *If money was accepted with the original application then it is likely coverage started prior to the delivery* of the policy to the owner and the **date on which coverage began**, called the "**issue date**" will be listed in the policy. *If any other requirements need to be met such as collecting the first premium, the producer should instruct the policy owner that coverage is not effective until the first premium* is paid and the applicant would have to sign a statement that the insured's health had not changed since the date the original application had been taken.

The coverage begins according to the contract or whenever the conditional receipt, which may have been taken originally with the application, indicates. It is generally considered the right of the company to decide when coverage begins but carriers are of course bound to the principals of contract law as to when an agreement is formed and effective on both parties.

If an initial premium was collected with the application but, after underwriting, a higher (rated) premium was assessed then the insurance company is making a **counteroffer** to the applicant and there is no coverage until or unless the applicant pays the higher premium amount offered by the company.

SECTION IV)

TAXES, RETIREMENT AND OTHER INSURANCE CONCEPTS

(8 QUESTIONS - 16% OF TEST)

A) Third Party Ownership

Third party ownership means the owner of the policy is not the insured. An example is a parent applying for coverage on the life of a child. The most common issue of third party ownership is in the case of the business insurance use of life contracts to fund "buy-sell" and "key man" situations. Through third party ownership, individuals, companies and business owners and partners can be protected from the possible economic loss suffered from the death of a key employee or business owner. **For third party ownership to be valid, insurable interest between the applicant and the insured must exist at the time a policy is issued**

B) Group Life Insurance

Most group life is written as employer - employee group term life. Group life varies from individual life in both its underwriting and some policy clauses. **The coverage is usually one year term insurance**, but could be universal life or even a permanent variety (very rare). The **Characteristics** of Group Life include:

- All employee contract rights exist under one **master contract**, which is held by the employer and the employees are "enrolled" into the plan. If the employer cancels the contract then employees have no coverage.
- Cost is lower than individual coverage (for the relatively small amounts of coverage involved)
- Cost based on experience of group
- Benefit levels constant to all individuals within a group (cannot discriminate)
- Insurability not considered (a group member can be terminally ill and still receive coverage)

Group life is also issued to debtors and common creditors and is called "**group credit life.**" Credit life is often very expensive when compared to the individual purchase of term insurance, especially for larger amounts of coverage.

■ **Group conversion option** - upon leaving the group, the employee has a **31 day period** to convert the coverage from group term **to an individual permanent contract** offered for sale by the company at guaranteed insurable rates. This option is great for the sick or ailing older employee who may otherwise be uninsurable, but it helps to create phenomena known as "**adverse selection**". > **Adverse selection** occurs when a pool of people are placed together such that the rates charged are too low relative to the risk to which the insurance company is actually exposed. If the covered employee who leaves a group (for any reason) dies before the conversion is selected then they are automatically covered (as long as they died within 31 days of leaving the group coverage).

■ Contributory vs. Noncontributory

- **Contributory** Group Life (most common form) **means the employee and employer share the cost** (in the past the ratio of payments required was such that at least **75%** of those employees eligible had to participate. The main idea was that since the employees are "contributing" toward cost, they therefore have a voice in the plan selected).
- **Non-contributory** Group Life **means 100%** of those eligible are covered because the employer is picking up the entire cost and therefore the individual has no choice (but to be covered for free) in plan selection.

C) Retirement Plans

Traditionally in the United States life insurance companies have issued plans, including forms of annuity as well as death benefit contracts, to help individuals save and prepare for retirement income. The money put into these vehicles **earns income that is "tax-deferred", meaning no income tax is owed or due until the income they provide is paid out, usually at retirement age.** The incomes are designed to replace working income that becomes minimal or ceases at old age.

■ **"Tax-Qualified Plans"** come with strings attached. This means the plan must meet Internal Revenue Code rules to enjoy not only tax-deferred income growth BUT **to also the ability to INVEST with "pre-tax dollars"**. Pre-tax dollars is income which is earned and would otherwise be income taxable immediately except that they are dollars contributed to a "qualified plan" and will not be taxed until the future when such money is withdrawn from a plan. Some common tax qualified plans available to individuals and group employees include the IRA (Individual Retirement Arrangement), SEP, 401(k), ESOP and PROFIT SHARING, among others. Annuities are often used by consumers on a qualified basis as their vehicle of choice for their IRA. While life insurance can be purchased in a qualified plan to a limited extent, it usually is not because any cash accumulation is already earning interest on a "tax-deferred" basis.

■ **"Nonqualified Plans"** are the flip side to the qualified tax plans discussed above. These also utilize tax-deferred growth of income during an accumulation period BUT **"after tax dollars"** are contributed into the plan. There is no deductibility of contributions into the nonqualified plan and only income accumulation is tax deferred. **Most purchases of life insurance are nonqualified (premiums are not deductible).**

D) Business Insurance

(EVEN IN THE CASE OF BUSINESS USES of life insurance, premiums paid are nonqualified and therefore not deductible although the death benefit is paid income tax free).

■ **Business Insurance** is used to protect companies and business partners from the possible economic loss suffered due to the unexpected death of a key employee or partner. The main idea is to use life insurance proceeds to continue the business when a key person in the business has died, retired or become disabled. Life insurance is purchased and death proceeds are used to keep the business alive or to provide funds for the purchase of the business. Life insurance can be used to reward long term employees (you can favor one employee over another because the purchase is nonqualified (cannot be written off as a business expense by the business)).

E) Social Security Benefits and Taxes

Every working American who is not under an alternate pension program authorized by law, has a Social Security Tax amount deducted from wages which is matched by an employer. Since individual earnings differ, the actual benefit amount paid varies according to wages earned during various accumulation periods. Social security benefits are referred to as "oashdi" benefits (old age, survivorship, and hospitalization and disability income benefits). Available benefits, by age of qualification include:

- **Widows or widowers** as young as young as age 62 (reduced benefits) or receive full benefits at age 65 if born before 1940. (The eligibility age to receive full benefits is gradually increasing to age 67 for widows and widowers who were born in 1940 or later.)
- **Widows or widowers who are disabled** as an early an age as 50
- **Covered worker's children can get benefits at any age if they were disabled** before age 22 and remain disabled. Under certain circumstances, benefits also can be paid to your **stepchildren, grandchildren or adopted children**
- Widows or widowers at any age if caring for a deceased worker's child. This → **"survivorship benefit" is paid as long as a minor child (up to age 18, and to age 19 if still in high school)** is being cared for. After the youngest dependent child reaches age 18, the benefit ceases and the surviving spouse will be "blacked-out" from a benefit until he or she reaches retirement age (see "widow/widower blackout" period below).
- **Dependent parents** age 62 or older.
- If you have been **divorced**, your former wife or husband who is age 60 or older (50-60 if disabled) **can get benefits if your marriage lasted at least 10 years.**

The "**widow blackout period**" should always be considered when discussing the needs of younger people. Since the children of a deceased person who is eligible for benefits are themselves eligible, a surviving spouse loses the income provided by the Social Security Survivorship benefit when the youngest child reaches 18. *If this surviving spouse is under age 62, they receive no further benefit until they are eligible again because of attaining the qualifying retirement age.* > The main concept is that LIFE INSURANCE PROCEEDS CAN EASE THIS BLACKOUT PERIOD.

A worker normally must have **40 quarters, or ten years, of coverage under SS to be "fully insured"** under the system. Until a worker is "fully insured" they are considered "currently insured".

Also do not forget the whopping "**death benefit**" paid to qualifying taxpayers which is a *one-time payment of \$255* that can be made when you die if you have worked long enough (that's right a full 25,500 pennies).

A working knowledge of these Entitlement benefits under Social Security is very important for the life insurance producer to master. The unexpected or premature death of an individual takes with it the income produced by that person and can be devastating to all those left behind who relied on this now lost income. The purpose of a life insurance policy is to provide a lump sum of money that can be used to generate income to replace the lost earnings due to death. *The retirement (old age) and survivorship benefits offered by Social Security should be factored into the equation of potential lost income amounts and life insurance amounts that can be relied upon to replace the total lost income experienced by potential customers.*

F) Tax Treatment of Insurance Premiums and Proceeds, Dividends

There are three fundamental taxes to consider with life policies, when making a life insurance purchase:

- ① **Premiums dollars** paid by individuals for their life insurance **are with "after tax" dollars**. This means premium payments **are not deductible from income (with the exception noted below under "Group Life")**.
 - ② The proceeds **of life insurance** (the amount paid by the insurance company upon the death of the insured) passes to the individual's estate or named beneficiary **FREE OF INCOME TAX. This applies to individual and group life proceeds.**
 - ③ **Estate Taxation** – life insurance proceeds *are considered to be part of the insured's estate* based on policy ownership and are therefore includable in the value of a decedent's estate. This could subject proceeds to estate taxation if the total value of the estate is great enough (the amounts subjecting a policyowner to an estate tax burden change annually and are in a state of flux that is expected to be resolved (one way or another) by 2011). An estate tax is a special and different part of the Internal Revenue Code and it should not be confused with the income tax. The estate tax is a tax on the transfer of property from one person to another at death (of a wealthy individual).
- **Life Premiums Paid by the Individual** - are not generally tax qualified and therefore, after tax dollars must be used (exceptions would be the purchase of life insurance with contributions to qualified retirement plans).
 - **Life Premiums paid by an employer are usually** not deductible unless they are paid **under** a group life plan by a **corporation** as an expensed item. Deductible premiums on group life: It must be **term** life and only the premium cost of the first \$50,000 of death benefit amount is deductible. If term premium is in excess of the cost for \$50,000 of death benefit, then the extra premium is considered wages, subject to income taxes by the employee and FICA taxes by both parties and deductible by the corporation as a salary expense.
 - **Dividends** paid by a mutual company on a participating life contract **are not income taxable** (whether paid on an individual or group life contract). They are **viewed as an overcharge of premium** and the dividend is looked upon as **a refund of this overcharged premium** and not as income.

■ **Modified Endowment Contracts (MEC)** (Current Taxation: June 21, 1988 to present)

Whether or not a current contract is considered to be "life insurance" and therefore will enjoy "tax-deferred" cash value accumulation depends upon a **7-pay net premium test**. Cumulative premiums (total paid from the beginning of policy) on a life contract may not exceed the cumulative payments under a 7-pay net premium basis. If premium payments exceed this 7-pay test (i.e., *a MEC would be any contract with fully paid premiums on a basis of 6-pay life, 5-pay, etc., down to a single premium payment policy*), the contract no longer qualifies as life insurance. Instead, the contract becomes a "**modified endowment contract**."

People have been attracted to such short pay (limited pay whole life) because it allows the owner to build cash values fairly quickly and to enjoy tax-deferred accumulation and get significant income returns. In the past, this fast accumulating income could be readily accessed without penalty. That is until June 21, 1988, when the MEC rule was created under tax law by Congress to amend the life insurance definition established in the 1984 reform act (TEFRA).

A modified endowment will still treat accumulating cash values like any other life insurance contract, but any money received from dividends, loans, withdrawals or surrenders are treated the same as amounts received under annuity contracts: **last in-first out (LIFO)**. First money out is income and therefore income taxable plus a 10% tax penalty is due if the contract owner is less than 59 ½ years of age at the time of cash receipt.

For example, a SPWL is still life insurance with respect to tax deferred accumulation for cash values. However, any attempt to withdraw money creates a taxable event (if any income exists within the cash value). Leave the cash alone and it is life insurance, take money out and it is a modified endowment and treated like an annuity. If cash is never touched within the policy and the insured dies then the proceeds is paid income tax free just as with any other life contract.

This tax treatment stems from the 1984 tax reform which defined Universal Life as a life insurance contract but eliminated endowment insurance from meeting the new life definition and instead treated it like an investment. Therefore, the MEC rule can view SPWL (or anything less than 7-pay life) as both a life insurance policy and/or as an investment, depending on what action is taken by the consumer after purchase.

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

G) "**Accelerated Death Benefits – Living Benefits**"

This concept contractually allows the policyholder to **redeem a significant percentage of the death benefit (from 50% to 75%, depending upon state law and what an insurance contract offers)** while the insured is still alive if they meet a qualifying condition as stated in the life insurance contract. **This "Living Benefit" as it is sometimes called is triggered by a catastrophic health event such as terminal illness within the next 12 or 24 months** (depending on the carrier). More generous definitions may also pay some percentage of the death benefit when the insured suffers from a serious illness or **disease** (i.e. cancers, heart attack, stroke, kidney failure and coronary bypass surgery). *If a percentage of the death benefit is paid under this rider or clause then the balance of the death benefit is paid when the insured dies.*

MAIN CONCEPT: the policyholder doesn't have to die to collect some of the death benefit, if they qualify.

The insured is still living but can use the contract's stated percentage of death benefit for any purpose, without restriction, (pay medical bills, prepay funeral, nursing home care, mortgage payments, groceries, etc., ANYTHING!).

H) Endowment Insurance

Endowment contracts provide a death benefit but heavy **emphasis is placed on** the savings feature (**cash value**). Although the insurance coverage is for a specific period of time that is less than age 100, it is **still viewed as permanent** and not term insurance because of the cash value element. At the selected **“ENDOWMENT POINT,”** **the face amount of the policy is paid** in a lump sum to the owner. However, if the insured dies before the ENDOWMENT POINT, then (of course) the death benefit would be paid to the designated beneficiary.

An endowment life insurance policy has a **higher premium payment** than does a WL contract for a like amount of coverage because the endowment point of the contract is prior to age 100. **Since extra premium is paid because of a shorter payment time frame, the primary emphasis is on cash accumulation and the death benefit is a secondary concern.**

>Endowments provide the least amount of insurance coverage for each dollar of permanent premium spent.

NOTE: Since 1984, when the tax law defining "insurance" was revised by Congress, an endowment contract **no longer qualifies as a life insurance policy** and is today viewed as an investment (does not qualify for tax-deferred treatment). This means the income portion of cash value accumulation would be taxable annually as income. Consequently, Life insurance companies stopped marketing Endowment Life in 1984. However, all **previously issued endowment contracts were "grandfathered"** and the 1984 law does apply to them.

☞ **Example:** A policy called "**Endowment at age 65**" costs \$3,000 per year and provides a death benefit of \$100,000 for its 40 year old purchaser, Mr. Cotta Kold. Mr. Kold will pay \$3,000 for 25 years (a total of \$75,000). He has death benefit coverage to age 65, whereupon he will be paid the \$100,000 death benefit paid upon reaching age 65. Since he is receiving \$25,000 more than he paid, this is income and will be taxable. How did you know when the policy would endow? Because the **ENDOWMENT POINT is revealed in the policy name!**

Life Exam Prep Power Points

Checklist of concepts you must master to easily pass the State Life Exam.

- **Three** common characteristics of **WHOLE LIFE (WL)/Permanent**.
- **Term Insurance = No Cash Value; Know Term Riders &** also understand why it is different than WL.
- **Interest Sensitive Life:** Guaranteed versus No guarantee products.
- **Endowment Life** placed cash accumulation **AHEAD** of the Death benefit– not available since 1984.
- **Joint Life = “first-to-die”** and **Survivorship Life = “last-to-die”**
- **Annuity** is “reverse life insurance”--- usually **STOPS** paying when “annuitant” dies
- Understand **FIXED / VARIABLE / EQUITY INDEX**. Also the four annuity settlement arrangements.
- **Equity Index Annuity:** The contract owner **cannot lose principal** but can get above average returns
- Distinguish between **Representation (five elements) versus Warranty!**
- “Free Look” starts upon policy **DELIVERY**.
- “Initial” Premium = Statements in application **AND/PLUS** first premium **payment** (BOTH ELEMENTS).
- Know all **Ownership Rights** and owner can change “mode” at **ANYTIME**.
- **Beneficiary ideas:** Primary versus contingent AND revocable versus irrevocable and “common disaster.”
- **Minor Beneficiaries** named are not a good idea---know why.
- **Grace Period:** 31 days; know what happens 1) if insured dies during Grace period and 2) when GP ends.
- **Reinstatement:** 3-5 years and must be on automatic term to request it.
- **Policy Loan** says all debt (both principal and interest) is deducted when insured dies with a policy loan.
- **Be familiar with fine points** of each of the three NON FORFEITURE OPTIONS.
- Understand what “mutual” means and all seven DIVIDEND OPTIONS.
- **Incontestable Period runs TWO YEARS from the point of policy ISSUE DATE.**
- **Suicide EXCLUSION** runs **TWO YEARS** from the point of policy ISSUE DATE.
- **Age/gender Misstatement** is **NOT FRAUD**; Benefits are **adjusted** based on correct age/sex.
- Review **Policy Riders** and **Policy Exclusions** and know them.
- **Application Concepts** : two or three parties who **MUST sign an APPLICATION**.
- Any APP changes **MUST BE initialed by all parties** that originally signed the APP.
- **Money PLUS APP = “Conditional Receipt”** means **coverage BEGINS BEFORE** policy delivery usually.
- **NO \$\$ with APP = No coverage** until three conditions met: 1) **delivery**, 2) **1st payment** & 3) **good health**.
- **Insurable Interest** must be present to **OWN** a life policy on any life; this removes gambling element from insurance; **everyone has UNLIMITED insurable interest in THEIR OWN LIFE**.
- **Third party information** is allowed (APA, MIB); any mistakes can be changed on medical/credit records
- **HIPPA and HIV Consent** protect personal medical information of applicants – know these rights
- **Do Not Call Registry** can result in fines to producers who ignore phone numbers on the list
- **Fair Credit Reporting Act** means reporting agency must give free credit report when there is a problem.
- Understand difference between **Actual and Constructive delivery** of policy.
- **Group Conversion Option** = 31 days from date of leaving group coverage, no proof of good health needed.
- **Contributory** = 75% and **NON Contributory** = 100% (totally employer paid).
- Most **business purchases of Life** are NON QUALIFIED (**NOT tax DEDUCTIBLE**).
- **Social Security Concepts:** Know “Widow Blackout Period”; also Survivorship Benefit only up to age 18/19.
- **Taxation: Premiums generally NOT DEDUCTIBLE**
- **Taxation: Proceeds ARE NOT INCOME TAXABLE**
- **Taxation: Proceeds ARE generally INCLUDABLE** in the GROSS ESTATE OF policy owner.
- **Taxation: Group Term premium cost is DEDUCTIBLE** to Corporation if Death Benefit \$50,000 or less.

- **MEC is a “7-PAY LIFE TEST”** since 6/21/88.
- **Accelerated Benefit** = part of death benefit paid to alive insured when qualifying **EVENT** is present.

HOW TO USE THE POWER POINTS LIST

All of the concepts listed above with a “●” indicate a key probable state licensing exam question area. If you understand the power point shown then move to the next one and mentally review the next and then the next and so on. If you reach a power point about which you are uncertain or not confident then you should locate that topic area in the materials and study it more thoroughly. Once you are able to go through all power points with a clear understanding of the material included you are ready to easily pass the PART 1 portion of your state licensing exam. You should use the power points list both before and after you take your REQUIRED open book “NONSUPERVISED” exam.

NOTE> ALL EXAMS IN YOUR BOOK HAVE AN ANSWER KEY FOR SELF-GRADING EXCEPT THE NONSUPERVISED EXAM. ALL NONSUPERVISED EXAMS ARE GRADED BY DOHRN INSURANCE TRAINING ONLY: THIS IS A STATE REQUIREMENT. YOU MUST PASS THE NONSUPERVISED EXAM WITH 70% OR GREATER ACCURACY AND THEN DOHRN WILL REPORT YOUR SUCCESSFUL COURSE COMPLETION TO THE ILLINOIS DEPARTMENT OF INSURANCE.

STUDY LAW CAREFULLY...YOU MUST PASS IT OR NO LICENSE!!!

Be sure to go through Law nonsupervised exam and look up any answer you are not certain of. **DO NOT GUESS!!!!** This must be learned properly. The answers to law are supplied at the end of this helpful open book test.

OTHER KEYS TO PASSING:

- **Do your course exams in their proper sequence (Nonsupervised/Diagnostic/Simulated**
- **Do not skip any exam in your book. If you do not know the answer on a nonsupervised LIFE question...then, LOOK IT UP, NEVER GUESS!**

- You must complete and return the Nonsupervised (open book) Life test for grading and course certification.
- **The state exams will challenge those that are not unprepared. You have a time proven method to pass the first time in your hands right now, use it wisely and properly.**
- If you vary from this format, expect your chances of passing to diminish with each shortcut.
It costs \$106 to take the Promissor exam each time....resolve to pay this fee only one time and prepare the right way.

>>> RECOMMENDED STRATEGY FOR STATE EXAM

- Use the “know it or skip it” test method. If you are not certain, skip a question and return to it later.
- Go through all skipped questions and answer if you are fairly certain of the answer or skip again
- Review all unanswered questions and give it your best shot
- Once you are done, **GET OUT** and do not review questions already answered and change them!

GOOD LUCK AND MUCH SUCCESS TO YOU!