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Principles of Risk and Insurance

Lesson 1

Principles of risk and insurance

A. Definition
Risk: a condition with a possibility of loss (a situation with an exposure to loss)

Examples of risks
– exposure to germs or viruses
– activity that may result in injury
– losing a job
– starting a business
– owning real estate
– becoming a CFP® licensee (liability)

B. Concepts

1) Peril: the cause of a loss (Insurance covers economic loss from certain perils.)

Examples of perils
– fire
– windstorm
– liability
– collision
– theft
– sickness or injury

2) Hazard: a condition that may create or increase the chance of loss arising from a given peril (may also increase frequency or severity of the loss)

Examples of hazards
– building on an earthquake fault
– poor maintenance of a car's brakes
– not disposing of a Christmas tree
– working in a contagious disease lab

Applying the Facts

1. Which of the following is an example of a hazard?
   A. Wagering $100 on the outcome of Saturday's game
   B. Bringing a new product to market
   C. Purchasing a house
   D. The cause of a loss
   E. Building a house near a river

   Answer: E Owning a home near a river carries a physical hazard. Answers A and B are speculative risks. Answer C is a property risk.

3) Law of large numbers
As the number of independent events increases, the likelihood grows that the actual results will be close to the expected results. For this to work, the insurer needs a large number of similar (homogeneous) exposure units.

Insurance entails pooling of risks and transferring them to an insurance company to replace uncertainty (a possible large loss) with certainty (coverage in exchange for a premium).
4) **Adverse selection**
There should be the same proportion of good and bad risks in the group insured as there were in the one from which the statistics were taken. The tendency of the poorer-than-average risks to seek insurance to a greater extent than the average or better-than-average risks must be reduced (adverse selection).

**Morbidity** - The incidence and severity of sickness and accidents in a well-defined class or classes of persons

**Mortality table** - A statistical table showing the probable rate of death at each age, usually expressed as so many per thousand

5) **Insurable risks**
For an insurance company to assume a risk:
- There must be a sufficiently large number of homogeneous exposure units to make losses reasonably predictable.
- The loss produced by the risk must be definite and measurable.
- The loss must be fortuitous or accidental.
- The loss must not be catastrophic to the insurance company.

**Applying the Facts**
Which of the following is not one of the elements of an insurable risk?
A. There must be a sufficiently large number of homogeneous exposure units to make losses reasonably predictable.
B. Severity and frequency of loss are determinants of risk treatment.
C. The loss must be fortuitous or accidental.
D. The loss must not be catastrophic.

Answer: B Answers A, C, and D reflecting elements. Answer B is true, but it is NOT one of the four elements listed above.

6) **Self-insurance**
Self-insurance is a formal program of risk retention. The self-insurance business performs most functions of an insurance company for its own risks. This requires a large number of similar potential losses, the ability to predict overall losses with a reasonable degree of accuracy, and the establishment of a formal fund for future losses and their possible fluctuations. It is primarily used by but not limited to large companies.

**Example**
An auto manufacturer with many employees, multiple plants, equipment, vehicles, etc. can adopt a formal program of self-insurance for some or all of its risk exposures.

**Advantages of self-insurance to a company**
- The company can avoid the cost associated with commercial insurance (commissions, overhead, taxes, and profit).
- Reserves for future claims can be invested in short-term money market type instruments. The company can use the earnings to offset the costs of the program.
Disadvantages of self-insurance to a company
– The greatest disadvantage* is that it can leave the company exposed to a catastrophic loss.
– The company must duplicate the services provided by an insurance company.
– The company may have to pay income taxes on reserves held for future claims at year end.

Applying the Facts
Which of the following are disadvantages of self-insurance?
I. The self-insurer can deduct losses incurred.
II. A concentration of exposures could result in a catastrophic loss to the company.
III. The self-insurer must replace most of the services otherwise provided by an insurer.
IV. The possibility of higher income taxes exists because contributions to the self-insurance fund are not deductible during the tax year.
V. Because a sufficient number of similar exposures typically will not be obtainable, so the law of large numbers will not operate.
A. All the above  D. III, IV
B. I, II, V  E. III, IV, V
C. II, III, IV, V
Answer: C  The ability to deduct losses is an advantage. The question is asking about disadvantages.

C. Risk management process

Applying the Facts
Which of the following would not be an example of risk exposure to a client?
A. Ownership of raw land
B. Ownership of a luxury car
C. Adequate disability insurance
D. A sixteen-year-old son driving a sedan
Answer: C  Answers A, B, and D retain liability exposure unless adequate insurance was indicated.

D. Responses to risk

1) Risk control
   a) Risk avoidance
   b) Risk diversification
   c) Risk reduction
2) Risk financing
   a) Risk retention
   b) Risk transfer
Basic rules
– Coverage for potential catastrophes should be purchased first (life, disability, health, homeowners, and auto).
– Severity is more important than probability.
– High probability will mean high premiums or a decline of coverage by the carrier.

Methods to control losses

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<tr>
<th>Avoidance</th>
<th>Examples</th>
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<tbody>
<tr>
<td></td>
<td>– do not purchase property, but rent it</td>
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<td>– do not buy a house with a swimming pool</td>
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<th>Diversification</th>
<th>Examples</th>
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<td>– store of assets or activities at different locations</td>
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<th>Risk reduction</th>
<th>Examples</th>
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<td>– sprinkler system/smoke detectors</td>
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<td>– safety programs for businesses</td>
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<td>– burglary alarm for home</td>
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<th>Retention</th>
<th>Examples</th>
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<td>– deductibles in insurance policies</td>
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<td>– coinsurance in insurance policies</td>
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<td>– self-insurance</td>
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<th>Transfer</th>
<th>Examples</th>
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<td>– insurance</td>
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<td>– hold harmless agreements/hedging contracts*</td>
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<td>– incorporation of your business*</td>
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* This is also called risk sharing. These are not insurance transfers (transfers affected by contract such as subcontracting the job to another contractor).

Applying the Facts

1. The following are methods of handling risk:
   A. Risk avoidance
   B. Risk retention
   C. Risk transfer
   D. Risk diversification
   E. Risk reduction

Match the method with the applicable situation:

A. Coinsurance
   
B. Taking a cab rather than buying a car
   
C. High limits of insurance
   
D. Wearing seat belts
   
E. Storing inventory at separate locations

Answers:  B, A, C, E, D

2. Health saving accounts (HSAs) entail which of the following risk management techniques?
   I. Risk avoidance
   II. Risk retention
   III. Risk reduction
   IV. Risk diversification
   V. Risk transfer

Answers:  I, II, III, IV, V
A. I, III, IV  C. II, V
B. II, III, IV  D. III, IV, V

Answer: C  HSAs require high deductibles. The high deductible is the risk retention; the insurance is the risk transfer.

Guidelines for risk management

– For risks that involve high loss severity and low loss frequency, the most suitable technique is probably risk transfer (insurance).
– For risks that involve high loss severity and high loss frequency, the most suitable technique is probably avoidance. Why? Insurance premiums would be prohibitive.
– For risks that involve low loss severity and high loss frequency, the most suitable techniques are probably retention and reduction. Why? High frequency again implies that the transfer will be costly.
– For risks that involve low loss severity and low loss frequency, the most suitable technique is retention. Why? These risks seldom occur, and when they do, their financial impact is inconsequential.

Applying the Facts

1. The Purple Roof Inn motel chain has a problem with missing towels. They experience a 5% loss probability each month. This is an example of which of the following?
   I. High severity    III. Low severity
   II. High frequency   IV. Low frequency
   A. I, II    C. II, III
   B. I, IV    D. III, IV

   Answer: C  Five percent each month is 60% per year (high frequency), but the cost of towels is low severity.

2. What is the most effective way(s) for the Purple Roof Inn chain to manage the risk in question 1?
   I. Risk avoidance    IV. Risk diversification
   II. Risk retention    V. Risk reduction
   III. Risk transfer
   A. I, II, III    C. II, III    E. IV, V
   B. I, II, V    D. III, IV

   Answer: B  Much of the risk will be retained. However, risk reduction (limit the number of towels per room) or risk avoidance (no towels in exercise room) may reduce the exposure.

3. Which one of the following reflects a good rule of risk management?
   A. Protect small uncertain costs with insurance
   B. Insure rare, low-cost potential losses first
   C. Consider the potential amount of the possible loss first
   D. Consider the probable chance of each individual loss
Answer: C Large loss exposures must be insured above all. Answers A and B can be retained. Answer C would have the greatest effect on the insured. Answer D is impractical.

4. Steel Building Partners (a general contractor) erects multi-story buildings. All construction employees are insured by Workers’ Compensation and employer provided group disability insurance. Construction sites maintain elaborate safety procedures and equipment. Which answer below includes two methods of handling risk currently used by Steel Building Partners?
   A. Risk transfer and risk reduction
   B. Risk retention and risk avoidance
   C. Risk avoidance and risk diversification
   D. Risk sharing and risk transfer

Answer: A The insurance is risk transfer, and the safety equipment is for risk reduction.

E. Legal aspects of insurance
1) Principle of indemnity
   A principle underlying insurance contracts (other than life insurance) under which the insurer seeks to reimburse the insured for approximately the amount lost, no more and no less.

Applying the Facts
Identify a method implemented to enforce the principle of indemnity?
   A. Cash value   C. Waiver of premium
   B. Subrogation   D. Adhesion

Answer: B The four principles supporting indemnity include (1) insurable interest, (2) the concept of actual cash value, (3) other insurance (limit the ability to profit from a loss), and (4) subrogation.

2) Insurable interest
   A right or relationship with regard to that which is insured so that the insured will suffer financial loss from a loss.

NOTE: Insurable interest must operate at the issuance of an insurance policy AND at the time of loss in property and casualty insurance. With life insurance, insurable interest must operate at the time of issue but does not need to be present at the time of death.

Example
Terry Smith and John Patter own a building together. They buy property insurance and enter into a cross purchase buy-sell agreement funded by life insurance. Terry sells his interest to John. Terry no longer has an insurable interest in the building for property insurance. (NOTE: The insurable interest is based on the co-ownership of the building by John and Terry.) Regarding the life insurance, John can continue to own the life insurance policy on Terry (and collect on the death benefit if Terry dies) although an insurable interest no longer exists. This is also true of John’s policy owned by Terry.
Applying the Facts

1. Mark Markelwiz and is a valuable employee to ETP, Inc. ETP acquires a key person insurance policy on Mark, and Mark buys a personal policy to benefit his wife. After a few years, ETP terminates Mark but keeps his policy in force. Two years after ETP terminates Mark, he dies. Which of the following is true?
   I. Presuming Mark paid the premium on his personal policy, his wife will get the benefits.
   II. ETP can collect the life insurance benefits from the insurance company on Mark’s life.
   III. Mark’s wife can collect ETP’s policy benefits because life insurance is a bilateral contract.
   IV. ETP cannot collect the life insurance benefits from the insurance company on Mark’s life because they no longer have an insurable interest.
   
   A. I, II    C. I, IV
   B. II, III    D. III, IV

   Answer: A  ETP had an insurable interest at the time the policy was issued. ETP does not need an insurable interest at the time of claim. Insurance is an unilateral contract.

2. Five years ago, Harry purchased a $1 million life insurance policy with XYZ Insurance Company. He named his wife Dottie the primary beneficiary. Harry divorced Dottie a year ago and married Gloria. He died in an automobile accident yesterday. To whom will XYZ Insurance Company pay the benefits?
   A. To his estate
   B. To Dottie
   C. To Gloria
   D. To no one until his estate is settled
   E. The policy will be subject to rescission.

   Answer: B  For the insurance company to acknowledge the change, a change of beneficiary or ownership form must be submitted. After a life insurance policy has been issued, beneficiary designation and ownership can be transferred to anyone. Insurable interest is not required.

3. An employer cannot purchase or own a policy in which of the following circumstances?
   A. Key person of the company    C. Deferred compensation
   B. Stock purchase agreement    D. Cross-purchase agreement

   Answer: D  In a cross-purchase agreement, no insurable interest exists for the company (Stockholder buys other stockholder's interest.) Answers A, B, and C indicate insurable interest.
4. Lupe Lopez owns an office building. On the first of the month, she sells the building but doesn't cancel the building's insurance coverage. If the building is damaged, will she be able to collect benefits?
   A. Yes, Lupe was the last party to pay the premium.
   B. Yes, she still has an insurable interest.
   C. No, she doesn't have an insurable interest.
   D. No, the damage wasn't insured

Answer:  C The carrier will research the ownership of the building and deny the claim.

3) Contract requirements
   Certain elements must apply for a contract to be legally enforceable.
   – There must be an agreement preceded by offer and an acceptance by the one to whom the offer is made (the application).
   – There must be consideration (generally money).
   – The principal must have legal capacity to execute contracts.
     1. Incompetent or intoxicated adults have limited or no capacity to execute contracts.
     2. Minors may have capacity to contract for necessities only. (Adult must sign as owner.)
   – The contract must be for a lawful purpose (unlawful - kill someone for benefits).

4) Contract characteristics
   Unilateral
   Only one of the parties to an insurance contract (the insurer) makes a binding promise that if broken breaches the contract.

   Adhesion
   Contract is accepted "as is" or not at all. It is not a regulated contract.

   Special note on adhesion
   Because insurance policies are generally contracts of adhesion is in the event of ambiguity in the terms. The courts are likely to rule in favor of the insured and against the insurer.

   Waiver provision
   Only president, vice president, secretary, etc., may alter contract; it must be accepted "as is." Agents cannot change the contract terms.

Applying the Facts
When Bernie’s life insurance contract was delivered, the insured refused to accept the amendment to the policy. What action should the agent take?
   A. Void the amendment
   B. Delete the amendment from the policy
   C. Return the policy to the company

Answer:  C This situation is about waiver provision. Neither the agent nor the insured can alter the contract.
Aleatory Contract
With insurance, the amount of dollars spent by the contract parties is typically unequal. Insurance is an aleatory contract because as an insured may pay large premiums and receive no proceeds from the policy. Conversely, an insured may pay only a small premium and receive a large benefit from the insurer.

Rescission
The contract is deemed null from its beginning due to fraud, misrepresentation, concealment, or mutual mistake(s) as to a material fact.

Example
Sue applies for health insurance, but she conceals certain medical information she considers unimportant. Two years later, she has a major operation from a health problem that was concealed medical information part of the application. What will the carrier do? The carrier will refund the premium paid and rescind the contract.

Reformation
When the contract between the parties fails to express the original intent of the parties, the contract can be amended.

Example
Dottie bought a universal life policy in 1988. She was told she would pay $10,000 of premium on a $1,000,000 policy. No illustration or disclosure was provided to her. Years later, the carrier informs Dottie that to keep the policy in force, she must pay $20,000 per year. Dottie should hire an attorney and force the carrier to make the written contract conform to the original agreement.

Collateral source rule
In tort liability, the plaintiff's measure of damage should not be mitigated by payments received from sources other than the negligent party/tortfeasor.

Example
If Penny Pedestrian is injured by Ricky Reckless and Penny has her own insurance to compensate for the injury, she can still sue Ricky for the amount of medical expenses and lost income she would have incurred had there been no personally owned insurance.

Subrogation
When an insurer pays a claim, it takes over the legal rights its insured had against a negligent third party.

Example
The insurer first pays under collision coverage for the damage to the insured's car caused by the negligent driver of another car. The insurer then takes over the rights of the policy owner to sue that negligent driver (by subrogation).

Applying the Facts
Jane is injured in a car accident. She has a personal disability policy that will replace all of her lost income. Under which doctrine can she also collect from the person at fault?
A. Collateral source rule  C. Subrogation
B. Negligence per se      D. Absolute liability
Answer: A  This situation reflects the collateral source rule.

Parts of the insurance contract
Declarations – factual statements that identify the specific person, property, or activity being insured and the parties to the transaction. They are specifically-printed for the individual contract and are not pre-printed like the other parts of the contract.
Definitions – This part explains the key policy terms.
Insuring agreements – This part spells out the basic promises of the insurance company.
Exclusions – This part spells out the circumstances when the insurer will not pay.
Conditions – This part spells out in detail the duties and rights of both parties.

Applying the Facts
“Notice of loss” requirement would be found in which part of the insurance contract?
A. Declarations  C. Exclusions  E. Conditions
B. Definitions  D. Insuring agreement

Answer: E  Notice of loss is one of the duties of the insured.

5) Policy ownership
Life insurance is a financial asset. It may have a cash value, and it typically has a death benefit. The policy may be owned by the insured, an applicant owner (like the beneficiary), or any party with an insurable interest. The owner can transfer (assign) the policy to someone else, receive the cash values or dividends, borrow against the cash values, or change the beneficiary. At the death of the insured, the beneficiary becomes the owner of the policy.

6) Beneficiary Designation
The beneficiary is the person named in the contract to receive all or a portion of the proceeds of the policy. A beneficiary may be primary or contingent. The primary is the first party entitled to the death benefit. A contingent beneficiary is entitled to the proceeds if the primary beneficiary has died or if the primary beneficiary disclaims the proceeds.

NOTE: A change in ownership does not automatically change the beneficiary.

Applying the Facts
Alice Williams wants to change the beneficiary of her insurance policy to Bobby Taylor, her boyfriend. Alice, single, feels she will get an engagement ring shortly. Can she change the beneficiary?
A. Yes
B. No
C. No, not without the consent her current beneficiary.

Answer: A  After issuance, the policy owner can change the beneficiary to anyone. Nothing indicates that Alice is not the owner.
Analysis and evaluation of risk exposures

A. Personal
1-5) Death, Disability, Poor health, Unemployment, and Superannuation
Opportunities to manage the risks

Superannuation
Superannuation is the risk that an individual (or couple) will outlive his (their) money.

B. Property
1-3) Real, Personal, and Auto
Managing risks and costs

C. Liability
1-3) Negligence, Intentional torts, Strict liability
A tort is a wrongful act other than a breach of contract for which a civil action may be brought against the tortfeasor. A tort is generally regarded as a crime.

Legal Liability

Intentional Tort – infringement of rights
(assault/libel/slander)

Unintentional Tort

Negligence’s
Attractive nuisance
(swimming pool / vacant lot)
Negligence per se
(violate a statute)
Strict liability
(product liability)
Absolute liability
(keeping of wild animals)
Vicarious liability – respondeat superior
(principals responsible for their agents)

Defenses
Assumption of risk
(skiing, stock car races)
Contributory
(jaywalking, drunk driving)
Comparative
(A is 20% negligent, B is 80%)
Last clear chance
(road rage)

Intentional tort
A deliberately performed act such as assault, battery, libel, slander, or false arrest

Unintentional tort
Negligence or carelessness
Attractive nuisance
A situation in which a high degree of care is imposed on the land occupier for certain conditions on the land

Examples
A pool which isn't screened or fenced, vacant land where children play, or land with access to a river or lake, etc.

Negligence *per se*
A situation where the standard of care is set by a statute. Examples: school zone, crosswalk, etc.

Strict liability
Generally limited to manufacturers and distributors of products found to be defective
Examples: Romaine lettuce with e. coli bacteria, Ford Motor Company, Merck, etc.

Absolute liability
An extra hazardous condition which results in losses to others. Examples: keeping of wild animals, blasting, etc. Workers' compensation also falls under absolute liability.

Vicarious liability (respondeat superior)
When one person is held liable for the negligent behavior of another person

Example
The branch manager at the broker-dealer is responsible for the representatives, or a manager at an insurance agency is responsible for the agents.

Assumption of risk
If one party recognizes and understands danger in an activity yet voluntarily chooses to encounter it, another party cannot be held responsible for the injury.

Example
Bill and Terry Sharp visited a lighthouse run by the National Park Service. Bill and Terry had to sign an assumption of risk form to go up in the lighthouse. Distracted by taking a picture, Bill fell and broke his leg. The National Park Service would try to limit its liability under Bill’s assumption of risk. In many ski lodges, the lift ticket has an assumption of risk disclosure.

Contributory negligence
Any negligence on the part of the injured party, although slight, defeats the claim.
Examples: jaywalking, driving while drunk, etc.

Comparative negligence
Any degree of negligence on the part of the injured party does not defeat the claim but is used in some manner to mitigate damages payable by the other party.

Example
The pedestrian is found 20% negligent (injured party), and the driver is found 80% negligent. Damages are adjusted proportionally.
Last clear chance
Any contributory negligence of the injured party will not bar recovery of damages if the other party, immediately prior to the accident, had a last clear chance to prevent the accident but failed to do so. Example: road rage

Applying the Facts
A. Assumption of risk  E. Attractive nuisance
B. Last clear chance  F. Comparative negligence
C. Absolute liability  G. Negligence per se
D. Subrogation  H. Vicarious liability

To which key term does each of the following refer?
1. The party negligently pulled out onto the highway in front of another auto. The second auto would still be liable for the accident if there was sufficient time to swerve out of the way, but that second driver failed to seize it. __________

2. The jury determined that the injured party was half to blame for her injury. She is awarded half of the damages incurred. __________

3. The party causes an extra-hazardous situation through dangerous activities. __________

4. The injured party recognized and understood the danger in an activity and voluntarily chose to encounter it; another party cannot be held responsible for the injury. __________

5. One party is held liable for the acts of another. __________

Answers: 1-B, 2-F, 3-C, 4-A, 5-H

Insurance needs analysis
NOTE: This is introductory material. Some questions precede certain material.

A. Life insurance (2 methods)
1. Capital utilization factors annuitization to fund future income needed but leaves no money at the end of the anticipated distribution period (calculate the present value of a future need).
Example
Arthur's survivors have the following needs:

- Mortgage payoff: $100,000 (PV)
- Education fund: 50,000 (PV)
- Spouse/dependent needs (children under 16): 200,000 (PV)
- Spouse needs (children age 16 to age 60): 150,000 (PV)
- Spouse needs (age 60 to life expectancy): 200,000 (PV)

Total needed now: $700,000 (PV)

If Arthur already has coverage of $100,000 of group life insurance and $250,000 of term insurance, how much additional life insurance is needed?

Answer: $350,000 However, at the end of the spouse's life expectancy, all the insurance proceeds will be utilized.

2. **Capital retention or capital preservation** presumes that only interest is distributed. The original capital is still left at the end of the income period.

Applying the Facts
1. Tom, the sole provider for his family, is married and has a 6-year-old son. He earns $120,000 per year. When he dies, he knows his wife will receive $20,000 from Social Security. What amount of money will provide an equivalent income, without invading principal, if the money is invested at 7%?
   - A. $1,428,571
   - B. $1,528,571
   - C. $1,714,286
   - D. $1,814,286

Answer: B ($120,000 - 20,000) $100,000 ÷ .07* = $1,428,571 plus money for year 1 $100,000 Total $1,528,571

Tom's wife can't wait until the end of the first year for income. (This is not a time value of money calculation.)

2. If John dies, he wants his wife to have yearly income of $36,000 that will increase with inflation (4%). He can realize a net investment return of 7%. Use a capital retention calculation to determine how much insurance he should purchase.
   - A. $514,285
   - B. $852,000
   - C. $1,200,000
   - D. $1,236,000
   - E. $1,248,007

Answer: D $36,000 ÷ .03* = $1,200,000 plus money for year 1 36,000 Total $1,236,000

* To find the divisor use 7% - 4%. When the question provides no number of years, presume it is a capital retention question.
**B. Disability income insurance**
Disability carriers will typically issue only about 50-60% of earned income. This may be improved by adding group disability coverage after the individual policy has been issued.

Applying the Facts
Karen is a marketing consultant. Her earned income is $120,000 per year. If she applies for an individual disability insurance policy, what amount will probably be the maximum monthly benefit?

A. $4,000  C. $8,000
B. $5,000  D. $10,000

Answer:  B  Approximately 50% of her earned income

**C. Long-term care insurance**
Long-term care insurance is generally purchased to cover a certain dollar amount per day (the per diem). Costs vary depending on geographic location and the coverage. Per diems typically range from $200 to $400+. With an aging population, the need for long-term care insurance continues to grow.

Applying the Facts
Why is it becoming more difficult for families to provide for long-term care?

I. Both spouses are growing old  IV. Divorce
II. No children are around to help  V. Significant wealth
III. Family members live apart

A. All the above  C. II, IV
B. I, II, III, IV  D. III, IV, V

Answer:  B  Wealthy people can afford to self-insure or purchase long-term care insurance.

**D. Health insurance**
Medical insurance costs are the most common type of employee benefit. Older plans imposed deductibles and coinsurances. Most new plans are HMO or PPO type plans.

Applying the Facts
Which of the following is generally not true about health insurance?

A. It is the most important type of insurance to most people.
B. It may be affordable as an employee benefit.
C. It is standardized by government regulations.
D. Individual health care is very expensive.

Answer:  C  Although there are certain mandates under the Affordable Care Act, health insurance is not standardized.
E. Property insurance
The types of property loss exposures facing families can affect either real or personal property. Insurance should be used for risks with high severity and low frequency. Retention should be used for risks with low severity and low frequency.

Applying the Facts
1. Insurance should be used for all the following risks except:
   A. Your home
   B. Home appliances
   C. Your new car
   D. Your collectibles

   Answer: B Home appliances would have low severity relative to the other answers.

2. All the following risks should be retained except:
   A. Auto - other than collision
   B. Earthquake
   C. Homeowners - medical payments
   D. Small used boat in the client's backyard

   Answer: B Earthquake would have high severity. The small boat is covered by the homeowner’s policy. Autos - other than collision - and homeowners have deductibles that can be increased to reduce premium cost (retained).

F. Liability insurance
Liability risk makes individuals responsible for certain losses they cause by injuring others or damaging property of others. Clients should have adequate liability protection which typically includes a personal umbrella liability policy.

Applying the Facts
Liability insurance is least likely to protect clients from which of the following?
A. Intentional injury to others
B. Personal liability injury
C. Negligent acts which create injury
D. Slip on a loose rug

Answer: A Most unintentional acts are covered. However, intentional acts (assault, for example) are excluded from a basic liability insurance policy.

Insurance policy and company selection
A. Purpose of coverage
Some companies only write certain types of coverage, like automobile insurance. Some companies specialize in high or unusual risk coverage, like Lloyd's of London.
Applying the Facts
Your client needs an individual health insurance policy. Which of the following insurance companies should the client contact?
A. Lloyd's of London
B. A property and liability insurance company
C. A life insurance company
D. A health and accident insurance company

Answer: D Insurers B and C may sell individual health insurance, but a health and accident company specialize in health insurance. Lloyd's provides specialty insurance.

B. Duration of coverage
Some coverage, like disability, may only be needed until retirement or age 65. Coverage, like life insurance, may be needed for lifetime or until children have completed college.

Applying the Facts
Tom is in poor health. He is 62 years old. He works for a major manufacturing company. He is covered under his company's group health insurance plan. How long does Tom need to work to maintain his health insurance?
A. To age 65
B. To 63-1/2
C. Until death
D. He can quit now.

Answer: B Tom can receive COBRA coverage for 18 months; then at 65 he will be eligible for Medicare coverage.

C. Participating policies
A participating policy pays annual dividend to the policyholder. A participating policy charges larger premiums (willful overcharge). If the extra premium is not needed, it is then returned to the policyholders as a dividend (generally tax free). Dividends are generally based on higher-than-expected investment return and/or lower-than-expected mortality and expenses. Originally, participating policies were only issued by mutual insurance companies (owned by policyholders), but stock insurance companies (owned by stockholders) may now offer participating policies.

In a non-participating policy, the company retains the profits (investment/mortality-expense) for its shareholders.

D. Company selection
1) Industry ratings
Rating services evaluate insurance companies based on their financial strength. Several companies rate life insurance companies.

<table>
<thead>
<tr>
<th>Rating services</th>
<th>Rating categories</th>
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<tr>
<td>A.M. Best</td>
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<tr>
<td>Standard &amp; Poor's</td>
<td>AAA to CCC</td>
</tr>
<tr>
<td>Moody's</td>
<td>Aaa to C</td>
</tr>
<tr>
<td>Weiss</td>
<td>A+ to F</td>
</tr>
</tbody>
</table>

Financial planners should choose a company that holds one of the three highest ratings from at least three of the rating services.
Applying the Facts

1. If a CFP professional wanted to research the background of an insurance company, which rating service would the financial planner review?
   A. S&P  
   B. Moody's  
   C. D&B  
   D. D&P  
   E. A.M. Best

   Answer: E Only A.M. Best provides detailed, historical data on insurance carriers. The others, except for D&B provide ratings.

2. Which is the highest A.M. Best rating?
   A. B++  
   B. A++  
   C. A+ Excellent  
   D. AAA  
   E. A+

   Answer: B Best uses 15 classes from A++ to F. The highest is A++. The second highest is A+.

2) Underwriting

Underwriting is the process of selecting and classifying exposures. The insurer seeks to accept only applicants who (on average) will have actual loss experience comparable to the expected loss experience that is built into the company’s premium rates. The underwriter must complete the following activities:

1. Cover a large number of individual insureds so that the law of large numbers works, and
2. Obtain homogeneity of insureds so that there is a reasonable equity between the better and poorer individual insureds

Process of underwriting

The underwriter uses five sources of information:

1. An application for insurance
2. Information from the agent or broker
3. Investigations
4. Information bureaus
5. Physical examinations or inspections

Loss adjustment

An adjuster is an individual who investigates losses. The adjuster determines the insurer's liability and the amount of the benefit. The adjustment process follows the following sequence:

1. Notice of loss - Notice by the insured to the company that a loss has occurred.
2. Investigation - The adjuster must first determine that there was a loss and then whether the loss is covered by the policy.
3. Proof of loss - Insured files a signed proof of loss.
4. Payment or denial
Applying the Facts
Which of the following steps in the adjustment process is correctly described?

A. Notice: A call to the company after the damage has been repaired is adequate but only if the insured has a bill for the repairs.

B. Investigation: Its primary purpose is to determine if a fraudulent claim is being filed.

C. Proof of loss: A phone call telling the agent that a loss has occurred is sufficient.

D. Payment or denial: The claim is covered under the contract, and the payment is made to the insured.

Answer: D  Answer A is false because the call to the company must occur before the damage is repaired. Answer B is false because of the word “primary.” One of the reasons for the investigation is to determine if a fraudulent claim is being filed, but it is not the primary purpose. Answer C is false because proof of loss must be filed (in writing) with the insurance company. (It cannot be submitted by phone.)
Property, Casualty, and Liability Insurance

Lesson 3

Property, casualty, and liability insurance

A. Individual

1) Homeowners

Homeowners insurance policies – covers dwelling, contents and personal liability under one policy

Declaration page – that part of an insurance policy containing representations of the applicant (name, address, etc.)

Section I coverages

<table>
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<tr>
<th>A. Dwelling</th>
<th>Limit of liability examples</th>
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<tbody>
<tr>
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<td>$500,000</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>B. Other structures</th>
<th>$50,000 (10% of A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>C. Personal property</td>
<td>$250,000 (50% of A)</td>
</tr>
<tr>
<td>D. Loss of use</td>
<td>$150,000 (30% of A)</td>
</tr>
</tbody>
</table>

Section II coverages

<table>
<thead>
<tr>
<th>E. Personal liability</th>
<th>Limit of liability examples</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$300,000 each occurrence</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>F. Medical payments</th>
<th>$5,000 each person; $15,000 each occurrence</th>
</tr>
</thead>
</table>

Deductible Section I: $500 loss deductible

Mortgagee: Bank of the South

Premium: $2,000 per year

Section I Coverage

Coverage A: Dwelling
Coverage A insures the dwelling and any structures attached to the dwelling such as a garage, decks, or fences. It also covers materials and supplies located on or next to the residence premises for construction, repair, or alteration of the dwelling or other structures on the residence premises.

NOTE: Land is specifically excluded from coverage.

Example
If the home is purchased for $500,000 and the land is worth $100,000, then the dwelling is worth $400,000.

Renter’s policies generally provide no Coverage A or B.

Coverage B: Other Structures
Other structures are set apart from the dwelling by a clear space. Examples include outdoor swimming pools, detached garages, fences, patios, or detached living spaces.

Coverage C: Personal Property
Personal property is covered anywhere in the world. The policy normally has special internal limits of liability (sublimits). Typical sublimits are the following:

- $1,000 for watercraft
- $2,500 for silverware (theft only)
- $1,000 for jewelry and furs
- $200 for money/bullion
Property specifically excluded includes:
– animals, birds, and fish  
– motor vehicles/aircraft  

property of roomers or boarders  
property in an apartment rented to others

NOTE: Homeowner’s policies generally will not cover exposures related to being a landlord. Endorsements may be added.

Applying the Facts
1. Mrs. Kindly rents a room in her house to Hank. She has contents coverage of $50,000 for the home of which $5,000 is in the rented room. Hank also has $5,000 of personal property. If the home burns down, how much will be paid to Mrs. Kindly for lost contents?

A. $40,000   
B. $45,000   
C. $50,000   
D. $55,000

Answer: B $50,000 less the $5,000 in the rented room. Mrs. Kindly should buy an endorsement that will cover the property in the rented room (Landlord's Furnishings). Hank's contents are not covered.

2. Mrs. Dodd rents part of her home to Betty. Betty owns too much personal property to keep in her room, so she has stored some of it in Mrs. Dodd’s garage along with her car. Mrs. Dodd also parks her car in the garage. If a fire burns the garage to the ground destroying everything there, which of the following items are covered by Mrs. Dodd’s homeowners policy?

A. Mrs. Dodd’s garage   
B. Mrs. Dodd’s car   
C. Betty’s personal property   
D. Betty’s car

Answer: C Mrs. Dodd's car will be covered under her auto policy. Betty's car will be covered under her own auto policy. Betty's personal property is specifically excluded. She is a renter.

Coverage D: Loss of Use
Coverage applies for additional living expenses arising from damage to the insured property. Coverage only pays for the necessary increase in living expense incurred by the insured to continue as nearly practical the normal standard of living.

Example:
The Browns incur normal monthly living expenses of $2,500. Because a fire made their home uninhabitable, their living expenses are now $4,000 (temporary housing, eating out). The carrier will pay the difference ($1,500 not the entire $4,000).
Section II Coverage (NOTE: Coverage E and Coverage F are contained in all policy types.)

Coverage E: Personal Liability
Coverage provides protection for damages for which an insured is legally liable arising out of bodily injury or property damage. The insurance company also agrees to defend the insured and has the right to settle any suit. Specific exclusions are the following.
– Liability arising from business activities or professional services
– Liability arising out of usage of motorized land vehicles (except recreational vehicles or motorized golf carts used on the property premises)
– Liability arising out of usage of watercraft except if the watercraft has less than 50 horsepower or is a sailboat of less than 26 feet

– Liability arising out of usage of aircraft
– Liability arising out of bodily injury to any person who is eligible for worker’s compensation

Coverage F: Medical payments
Provides very limited amounts ($1,000/$5,000 typically) per person of coverage for necessary medical expenses of persons other than the insured who are injured while on the insured location. This is NOT liability coverage.

Applying the Facts
Which of the following can be protected by Coverage E under homeowner’s policies?

A. 30' sailboat
B. Recreational vehicles away from premises
C. Vacant land - endorsed
D. Domestic employee covered by workers' compensation

Answer: C Sailboats longer than 26 feet are not covered. Recreational vehicles are only covered on the premises. There is an exclusion for workers' compensation claims.

Covered Perils - Basic, Broad, and Open Form

<table>
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<tr>
<th>Forms</th>
<th>Dwelling</th>
<th>Other Structures</th>
<th>Personal Property</th>
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<tr>
<td>Coverage</td>
<td>A</td>
<td>B</td>
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<td>D</td>
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<tr>
<td>HO-1 (dwelling)</td>
<td>Basic</td>
<td></td>
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<tr>
<td>HO-2 (home)</td>
<td>Broad</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>HO-3 (home)</td>
<td>Open</td>
<td>Open 10% A</td>
<td>Broad 50% A</td>
<td>Open 30% A</td>
</tr>
<tr>
<td>HO-5 (home) (HO 3-15)</td>
<td>Open</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>HO-8 (older home)</td>
<td>Basic</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>HO-4 (renter's)</td>
<td></td>
<td></td>
<td>Broad</td>
<td>Broad 30%C</td>
</tr>
<tr>
<td>HO-6 (condo owner)</td>
<td>*</td>
<td></td>
<td>Open</td>
<td>Broad 50%C</td>
</tr>
</tbody>
</table>

NOTE: Do not memorize these percentages for the CFP® exam.

*HO-6 actually has some coverage for A and B (named perils) for installed items like wall-to-wall carpeting and cabinetry. In addition, condo owners get $5,000 of loss assessment coverage (more can be purchased). Loss assessment provides protection against assessments made by the condominium association because of losses to collectively owned property.
Perils
– Basic form WHARVES / FLT
   Windstorm, Hail, Aircraft, Riot, Vandalism, Vehicles, Explosion, Smoke
   Fire, Lightning, and Theft

– Broad form (Everything in basic form plus RAF*)
   Rupture of a system, Artificially generated electricity, Falling objects,
   Freezing of plumbing
   *Royal Air Force or use FAR

– Open Perils
   The insurer agrees to pay for damage by any peril except those specifically excluded.
   Open perils coverage is generally the appropriate choice for the CFP® exam because it
   covers unusual risks that are not named under the Basic and Broad forms.

HO-2 versus HO-3
The HO-2 is broad form for all coverages whereas the HO-3 is open perils for coverages
A, B, and D. The HO-3 is much more comprehensive.

HO-3 versus HO-5
The only difference is that the contents are also covered under open form. Essentially,
the HO-5 is the HO-3/15. The HO-15 endorsement changes the broad form for personal
property under the HO-3 to open perils (same as the HO-5)

HO-4
This is a renter’s policy. It provides no coverage for the “dwelling” (Coverage A) since
the property is owned by others. It offers coverage for contents, loss of use and
comprehensive personal liability.

HO-6
This is a condominium policy. Normally the condo association covers the structure. The
condo policy provides for coverage for the interior. Loss assessment coverage provides
protection against assessments made by a condo association because of losses to
collectively owned property. Coverage A and C can both be changed by endorsement to
apply on an open-perils basis (best answer for exam).

Important differences between HO-4 and HO-6 policies:
– HO-4 is for renters; HO-6 is for condominium owners.
– HO-4 has broad coverage for contents and loss of use; HO-6 has open perils coverage
  for contents and broad coverage for loss of use.
– HO-6 actually has some coverage for A and B (named perils) for items installed like
  wall-to-wall carpeting and cabinetry. In addition, condo owners get $5,000 of loss
  assessment coverage (more can be purchased).
Applying the Facts
Regarding different forms of Homeowner’s insurance, which of the following are true?
I. Form HO-2 differs from HO-3 in that the HO-2 policy provides broad form coverage on the dwelling, other structures, and loss of use while the HO-3 offers open perils coverage.
II. Form HO-3 provides open perils coverage on the insured’s personal property.
III. Form HO-4 is a renter's policy.
IV. The form HO-6 loss of use limit is 50% of the policy limit on personal property.
V. Form HO-5 provides open perils coverage for personal property.
A. All the above D. II, IV, V
B. I, II, III E. III, V
C. I, III, IV, V

Answer: C Form HO-3 only provides broad form coverage on personal property. (Personal property may be called contents.) An additional endorsement’s HO-15 can be added to the HO-3 to provide open perils coverage on contents.

Exclusions (OPEN WIF)
Eight general exclusions that apply to all of the homeowner forms – ordinance of law, power failure, earth movement (earthquake), neglect, nuclear hazard, war, intentional loss, flood. Sinkhole is covered if it affects the stability of the house.

Applying the Facts
Which of the following are exclusions that generally apply to all of the Homeowner forms?
I. Earth movement IV. Riot and civil commotion
II. Intentional loss V. Explosion
III. Neglect
A. I, II, III, IV C. II, IV, V
B. I, II, III D. III, IV, V

Answer: B Answers IV and V are covered perils.

Scheduled personal property endorsement (floater)
Homeowner policies normally have limitations on personal property coverage that is easily stolen. Clients should cover valuable property like jewelry, golfer's equipment, stamps, coins, etc., by adding a scheduled personal property floater to their basic HO policy. Each item is usually appraised, listed separately and insured for a specified value. Coverage is "open perils" and is written on an agreed-value basis.
Applying the Facts
When fine art or antiques are insured under a homeowners policy by an endorsement, which of the following is true?
A. Coverage is usually on a replacement cost basis.
B. Coverage is usually on an actual cash value basis.
C. Coverage is usually provided on a valued basis.
D. The perils are the same as the homeowners policy to which the endorsement is attached.
E. Coverage limits are the same as the homeowners policy to which the endorsement is attached.

Answer: C Easily stolen items would be insured on an agreed-value basis. Coverage may also be available under a separate inland marine contract.

Replacement cost coverage versus actual cash value (ACV)
When losses are settled on a replacement cost basis, no deduction in benefits is made for depreciation. Under ACV, losses are settled under replacement cost less depreciation. For exam purposes, the dwelling (structure) will typically be covered under replacement cost coverage and personal property (contents) on an actual cash value basis. The problem with ACV is that the insured may not receive enough from the insurance company to replace the damaged item.

Example
A 10-year old refrigerator is destroyed by fire. It originally cost $900. A replacement costs $1,200. The adjuster estimates a refrigerator typically lasts 15 years. Therefore, it is two-thirds depreciated. The insured would get a benefit of one-third (5/15 x $1,200 = $400) less any applicable deductible. NOTE: The original cost is immaterial in the calculation of ACV.

Applying the Facts
1. Bud Wiser’s big screen/surround sound TV (replacement cost - $2,500) was stolen while he was on vacation (3/5ths depreciated). He has a HO-3 policy. Which of the following statements applies if the deductible is $250.00?
   A. He is entitled to a replacement cost benefit.
   B. He is entitled to ACV up to the limit of the policy.
   C. His policy provides the open form coverage.

   Answer: B No HO-15 endorsement is mentioned. Under ACV - $2,500 replacement cost of the TV less depreciation (3/5th of $2,500 = $1,500) equals $1,500 less deductible ($250) equals $750* benefits paid.
   * $2,500 - (1,500 + 250) = $750

2. Spencer Sportsfan bought a new surround sound 48” TV for $5,000 two years ago. The TV was completely destroyed by fire. His insurance policy covers personal property at ACV. If the company uses a replacement value of $5,000 and a 5-year straight depreciation schedule with a $250 deductible, how much will Spencer get from the insurance claim?
   A. $0 C. $2,750 E. $4,750
   B. $1,750 D. $3,750
Answer: C  Actual cash value (ACV) is replacement cost less depreciation. $5,000 less 2/5 of $5,000 (or $2,000) less $250 deductible.

Property loss calculations
For loss coverage under a typical homeowners policy, when the amount of the insurance is less than 80% of the dwelling’s replacement cost, the insurer will pay the greater of the following.
1. The actual cash value (ACV)* or
2. The amount determined by the use of the following formulas.
   Replacement cost × Coinsurance percentage = Amount of insurance required

   \[
   \left( \frac{\text{Insurance carried}}{\text{Insurance required}} \right) \times \text{Loss} - \text{Deductible} = \text{Amount paid by Insurance}
   \]

*NOTE: When the amount of dwelling insurance is ≥80% of the replacement cost, ACV is not used. Instead, apply the formula.

Use Replacement cost for applying the facts 1 and 2.

Applying the Facts
1. Lupita owns a home with a current replacement cost of $400,000 (ignoring the land). The home is covered under an HO-3 policy for $300,000 with coinsurance of 80% and a $250 straight deductible. A fire caused $100,000 of covered damages. How much will the insurance company apportion for this loss?
   A. $100,000   D. $94,000
   B. $93,500   E. $93,515
   C. $74,750

Answer: B

   \[
   \text{Replacement cost} \times \text{Coinsurance} = \text{Insurance required}
   \]

   \[
   \left( \frac{\$400,000}{\$320,000} \right) \times \$100,000 - \$250 = \$93,500
   \]

Why might someone be underinsured ($300,000)? Building costs could have risen faster than insurance coverage.

NOTE: If depreciation information is not given, ACV cannot be determined. For homeowners policies, the required percentage is always 80% of replacement value. However, for commercial buildings, the required percentage can be 90%. The CFP Board likes to ask the 90% question. The same formula is used for commercial property. In addition, all calculations are usually due to partial (not total) losses. Use the 80% replacement coverage requirement if no percentage is given.
2. Richard and Susan had windstorm damage to the office building that they co-own. The amount of loss was $10,000. At the time of claim, the FMV of the property was estimated to be $900,000, and the replacement cost of the building was $600,000 with a 90% coinsurance clause. How much of the claim was paid by the insurance company if they had $500,000 of coverage with a $250 deductible?

A. $5,923  
B. $9,009  
C. $9,027  
D. $9,259  
E. $9,750

Answer: B  
$600,000 x 90% = $540,000 insurance required  

$$\left[ \frac{500,000}{540,000} \times 10,000 \right] - 250 = 9,009$$

NOTE: The FMV of the property includes the building and the land. However, under commercial property forms, land is not insured.

3. Marilyn’s home suffers extensive roof and ceiling damage from a severe thunderstorm and tornado. The loss is $36,000. The replacement cost of the home is $340,000 although the fair market value of the land and dwelling is $480,000. The insurance company estimates the roof is 50% depreciated. Marilyn only has $260,000 of coverage “A” (the dwelling). Coverage “A” has a $1,000 deductible. How much of the claim will be paid by the insurance company?

A. $17,000  
B. $26,529  
C. $27,529  
D. $33,412  
E. $36,000

Answer: D  
When the amount of required insurance on the dwelling is less than 80% ($260,000 ÷ $340,000 = 76%), the insurance company pays the greater of ACV or replacement cost (less the deductible).

The amount the insurance company would pay under ACV is calculated as follows.

$$36,000 \times \frac{50}{100} = 18,000$$ less $1,000 (deductible) = $17,000

The amount the insurance company would pay under replacement value is calculated as follows.

$$\left[ \frac{260,000}{272,000} \times 36,000 \right] - 1,000 = 33,412$$

$340,000 replacement cost times 80% = $272,000.
4. Seven years ago, a commercial building was constructed for a cost of $500,000. Today, the replacement cost of the dwelling is $1,000,000. The property was insured for $750,000 using actual cash value. If the property suffered a total loss and had depreciated by 30%, how much would the insurance pay?
A. $175,000  
B. $250,000  
C. $700,000  
D. $750,000

Answer: C  The question says to use ACV. Actual cash value is the replacement value of $1,000,000 less depreciation of $300,000 (30% of $1,000,000) or $700,000.

5. Five years ago, Technical Tower, a commercial building was constructed for a cost of $500,000. Today the FMV of the property is $1,000,000. The land is worth $200,000. The property was insured for $700,000 with a 90% coinsurance provision and a $2,000 straight deductible. Last week a fire in the building caused $700,000 of covered damages. What amount will the insurance company pay for this loss?
A. $678,000  
B. $678,556  
C. $690,500  
D. $700,000

Answer: B  $700,000 * $700,000 = $680,556 less deductible 90% of $800,000* of $2,000

*$800,000 is the FMV (Fair Market Value) of the building less the land value. The FMV of the entire property includes the land. The replacement value of the building is the FMV less the land value ($1,000,000 - 200,000 = $800,000)

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2) Auto policy – The Personal Auto Policy (PAP)
   
   Declaration page - that part of an insurance policy containing representations of the applicant (name, address, description of auto(s), etc.)

<table>
<thead>
<tr>
<th>Coverages (example)</th>
<th>Limit of Liability (split limits)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Liability</td>
<td>$100,000 per injured person</td>
</tr>
<tr>
<td>B. Medical payments</td>
<td>$300,000 per occurrence (all persons)</td>
</tr>
<tr>
<td>C. Uninsured motorist (liability)</td>
<td>$50,000 property damage (others)</td>
</tr>
<tr>
<td>D. Damage to your auto</td>
<td>$5,000 per person</td>
</tr>
<tr>
<td>1. Collision loss</td>
<td>$15,000 per occurrence</td>
</tr>
<tr>
<td>2. Other than collision loss</td>
<td>$100,000 per person</td>
</tr>
<tr>
<td></td>
<td>$300,000 per occurrence</td>
</tr>
<tr>
<td></td>
<td>$500 deductible</td>
</tr>
<tr>
<td></td>
<td>$500 deductible</td>
</tr>
</tbody>
</table>
Applying the Facts
Perry purchased a 10-year-old compact car with 125,000 miles on its odometer. He wants adequate coverage while keeping the premium cost as low as possible. Which coverage is the least necessary?
A. Liability  C. Uninsured motorist
B. Medical payments  D. Collision

Answer: D A 10-year-old compact car with 125,000 miles can't be worth much. Perry needs liability, medical payments, and uninsured motorist protection.

Eligibility
The personal auto policy (PAP) can be written on eligible vehicles owned or leased by an individual or by a husband or wife living in the same household. A vehicle rented to others as a public or livery conveyance is not eligible and must be insured under a commercial policy. Eligible vehicles include private passenger automobiles, vans, and sport utility vehicles. However, vans and pickups are ineligible for coverage if they are used for transportation or delivery of goods and materials (need a commercial policy).

Applying the Facts
Which of the following is not a requirement for a vehicle to be eligible for coverage under a personal auto policy (PAP)?
A. It must be owned by an individual
B. It must be a private passenger automobile
C. It must be owned by a father and son not living in the same household
D. It must not be used as livery conveyance such as a taxi or limousine
E. It must not be rented to others

Answer: C Vehicles with other forms of ownership (father and son) can also be insured under the PAP, but only by endorsement.

Covered auto
A covered auto is any vehicle listed in the policy declarations. In addition, coverage includes three other categories of vehicles: newly acquired autos, trailers, and temporary substitute vehicles.

Newly acquired autos
If the new automobile replaces an existing vehicle, it is automatically insured for Parts A, B, and C. The situation is different for Part D. There is no automatic coverage unless the insurance company is notified within 14 days of acquisition of the new car.
Applying the Facts
John buys a van for business purposes. He requests coverage from his agent sixty (60) days after the date of purchase. The van is a substitute for his personal auto. Which of the following is true?
A. The van will be covered under his PAP.
B. The van will not be covered for physical damage because he waited beyond the 14-day period.
C. The van will not be covered because it is used in business.
D. The van will be covered because John called and requested coverage as a substitute for his personal auto.
E. The van will be covered because it will be owned by John and used as a private passenger automobile.

Answer: C The van needs to be covered by a commercial auto policy. The personal auto policy specifically excludes a van used for business purposes.

Temporary substitute vehicles
Any auto or trailer the policy owner does not own while used as a temporary substitute for any covered auto which is out of normal use because of breakdown, repair, servicing, loss, or destruction (a loaner)

NOTE: This last part only applies to Parts A, B, and C of the personal auto policy.

Who is covered?
- The named insured and spouse (living in the same household)

NOTE: If the spouse ceases to be a resident of the same household, he or she is still covered until the earliest of the following.
- the end of 90 days following the spouse's change of residency
- the effective date for the spouse's own new policy
- the end of the policy period
- A family member who is living in the same household
- Any person using your auto with your permission

Applying the Facts
Ned and Nellie Nasty have a shaky marriage and decide to live separately. Ned moves out of the house to his own apartment. Who needs to acquire a new personal auto policy?
A. Nellie
B. Ned
C. Neither
D. One of them in 90 days

Answer: D Whoever is the “named insured” under the policy may keep the coverage. The other insured has 90 days to get new coverage.
Special NOTE: This is a "real life" situation involving many of your clients (divorce, separation, living apart, etc.), and they don't even know they have a problem. Different states treat this situation differently. Contact your local agent for situations in your state.

Part A - Liability Coverage
Part A provides protection against judgments and covered exposures resulting from bodily injury and property damage liability deemed to have been caused by the insured. (The test may use the abbreviated term BI/PD.)

Single limit - each accident ($300,000)
– One amount applies in the aggregate ($300,000) to all bodily injury and liability claims arising from one accident.

Split limits - each accident ($100,000/$300,000/$50,000 - see page 3-8)
– The first limit ($100,000) is the maximum amount payable to any one person for bodily injury.
– The second limit ($300,000) is the aggregate that will be paid for all bodily injury claims.
– The third limit ($50,000) refers to the aggregate property damage claims.

Example
Mrs. Dilly, age 91, lost control of her car and crashed into a two-story house, collapsing the main support beam to the second floor. The house sustained $150,000 of damage. In addition, two children sleeping on the second floor were hurt ($200,000 claim). If she had $100,000/$300,000/$50,000 coverage, how much would the carrier pay?

– $200,000 for the children and $50,000 property damage

If she had $100,000 single limit, how much would the carrier pay?

– $100,000 in the aggregate - The insurer's liability limit is the most the company will pay regardless of the number of insureds, claims made, or vehicles involved in any accident.

Auto liability exclusion
One exclusion denies coverage for anyone who intentionally causes an accident. Another exclusion denies coverage to any other person, other than a family member, who uses your auto without your permission.

Example
A thief steals a car and causes an accident. If the car owner left the keys in the car, the accident victim could sue the car owner for negligence. The car owner is covered for liability, but the thief is not covered (no permission).

Part B – Medical Payments (Med-pay)
Part B provides payment for the reasonable and necessary medical expenses of an insured as a result of an automobile accident. Only those expenses for medical services rendered within 3 years of the date of an accident are covered.

Who is covered for medical payments?
– The named insured, spouse, and any family member while occupying a motor vehicle or when struck as a pedestrian by a vehicle
– Any other person who is injured while occupying a covered auto
Part C — Uninsured Motorist Coverage (UM)
The insurer agrees to pay compensatory damages that an insured is entitled to recover from the owner or operator of an uninsured motor vehicle because of bodily injury. The coverage applies to claims for medical expenses, lost wages, and pain and suffering but does not include punitive or exemplary damages.

Who is insured for uninsured motorist coverage?
– The named insured, spouse, and any family members
– Any other person who occupies a covered auto
– Any other person who is entitled to recover damages because of bodily injury to any of the previously mentioned persons is an insured.

Example
Darcy’s husband is badly injured and disabled in an auto accident. Darcy was not in the car. The other party was at fault. She is undergoing treatments for a mental condition she is suffering over her husband's disability. She may be entitled to recover due to her mental condition.

Applying the Facts
Tom was driving his car safely when he was struck by Bill's car. Dane was a passenger in Tom's car. Tom sued Bill and won a $15,000 judgment. Dane sued Bill for injuries from the accident. Whose losses does Tom's uninsured motorist protection cover?
A. Tom only
B. Tom, due to Bill's negligence but only if Bill is found to be negligent in a civil court proceeding
C. Tom and Dane
D. Anyone struck by Tom's vehicle
E. Dane's and Tom's injuries if Bill is found at fault

Answer: C Both Tom and Dane would be covered under uninsured motorist protection in Tom’s PAP.

Part D — Coverage for damage to your own auto

Collision
Collision is "the upset of your covered auto or its impact with another vehicle or object."

Other than collision
The coverage for loss "other than collision" is an open perils type of property coverage. The policy specifically designates several perils as "not considered collision." Examples include:
– breakage of glass
– loss caused by missiles
– falling objects
– fire, theft, or larceny
– flood

– earthquake
– windstorm, hail
– vandalism, riot
– contact with bird or animal
– explosion
Applying the Facts
John, while moving his car during a hurricane, hit a prize bull which had wandered onto the road. The bull crushed the front end of John's car. The car's airbag blew into John's face. John is sued by the farmer for negligent driving. Under which sections of his PAP policy would John typically be covered?
I. BI/PD    IV. Collision
II. Med Pay    V. Other than collision
III. UM
A. All of the above    C. I, II, IV
B. I, II, III    D. I, II, V

Answer: D The BI/PD (bodily injury/property damage) will cover the farmer's lawsuit. John most likely was hurt if the bull crushed his car. Hitting a bird or animal is covered by "other than collision" (not collision).

Claims adjustment procedure for property insurance
The following sequence must be followed as the insured pursues a claim.
1) Furnish a notice to the insurer (promptly)
2) Investigate the claim (suicide, carelessness, intentional, etc.)
3) File a proof of loss to the insurer (death certificate, police or fire report, etc.)
4) Pay or deny claim

Options of the insurer
Insurance contracts contain various provisions for settling claims. With a property loss, an insurer generally has three options in settling claims.

Replacement option - The insurer may repair or replace damaged property with that of like kind or quality rather than pay the actual cash value or replacement cost of the loss.

Abandonment or salvage - The insured must surrender ownership of lost or damaged property to the insurance company so that a total loss can be claimed.

Pair or set - The insurer may repair or replace any part to restore a pair or set to its value before the loss or to pay the difference between the actual cash value of the property before and after the loss.

Applying the Facts
What is one provision for an insured or insurer in settling property and casualty losses?
A. The insurer must reimburse the insured for any voluntary payments the insured makes to injured parties.
B. The insured may relinquish ownership of lost or damaged property to the insurer to claim a total loss.
C. The insurer must repair or replace damaged property with that of like kind and quality.
D. The insured must give the insurer notice of a loss immediately or as soon as practical following the loss.

Answer: D The key wording is must versus may.
3) **Umbrella liability insurance**
If "umbrella" liability insurance is given as an answer choice on the exam, it is always correct. Virtually every client needs umbrella coverage. The personal umbrella policy provides liability (BI/PD) coverage for catastrophic legal claims or judgments. The personal umbrella requires the policy owner to carry certain underlying liability coverage of specified minimum amounts in homeowners and auto policies.

**Claims**
If a claim is made under the underlying policy, the umbrella policy will pay its benefits only after the limits of the underlying policy(s) are exhausted. It superimposes an umbrella of protection above the underlying policy. If an underlying policy does not cover a loss that is covered under a personal umbrella policy, the umbrella policy then provides primary coverage for the loss subject to a self-insured retention. In essence, the umbrella provides broader perils coverage than the basic policies.

**Exclusions**
Important exclusions often found in personal umbrella policies include:
- Any act committed with the intent to cause personal injury or property damage
- Damage to property owned by the insured (You cannot sue yourself.)
- Business pursuits (owning a business)
- Rendering or failure to render professional services (malpractice)
- Directors' and officers' activities
- Workers' compensation obligations

**Example**
Tim Brown, CFP® has been sued for giving poor stock market advice. He carries $500,000 of liability coverage under his homeowner’s policy and a $3,000,000 personal umbrella liability insurance policy. Will either policy afford him any protection with regard to the stock market advice lawsuit? No, both policies have exclusions for business pursuits and professional services.

**Applying the Facts**
1. Tom built his large two-story house on the side of a mountain to view the sunset. Bill, whose house was built years ago, lived to the east. Bill's view of the sunset was restricted by Tom's house. Bill burned Tom's house down to the ground while Tom was away. Will Bill's personal umbrella policy cover Tom's home?
   A. Tom's policy will cover Tom's home.
   B. Bill's umbrella policy will cover Tom up to the policy limits.
   C. Bill's umbrella will provide no coverage.
   D. As long as Bill has basic liability coverage, his umbrella policy will provide coverage for Tom's house.
Answer: C Any act committed or directed by the insured with the intent to cause personal injury or property damage is excluded in an umbrella liability policy. Answer A is true but doesn’t answer the question. Tom’s policy may pay to rebuild Tom’s house. Then the carrier will subrogate Tom and sue Bill for the damage.

2. Rocky Reckless had a serious at-fault auto accident. He is being sued for $1,000,000 for bodily injury by the other person. He has the following coverage:
   - Auto $300,000/$500,000/$100,000
   - Umbrella $1,000,000 (It requires $300,000 of coverage.)

   If he loses the litigation, how much will his insurance company pay in total?
   A. $300,000 C. $800,000 E. $1,300,000
   B. $700,000 D. $1,000,000

   Answer: D Rocky carried $300,000 per person of underlying coverage. In this situation, he will be covered to $1,000,000 ($300,000 auto and $700,000 umbrella). The umbrella policy paid to the $1,000,000 claim less the underlying auto coverage.

3. Randy purchased a $1 million umbrella liability policy requiring him to carry $300,000 liability limits on his HO-3. However, his homeowner’s policy only has $100,000 of liability coverage. Due to a swimming pool accident, he is sued for $1,000,000. What amount of benefit will the umbrella liability policy pay?
   A. -0- C. $700,000
   B. $100,000 D. $900,000

   Answer: C Because Randy did not carry $300,000 of underlying liability coverage on his Homeowner’s policy, he will only have $800,000 of total coverage ($100,000 homeowners and $700,000 umbrella). Although Randy's underlying coverage was inadequate, the umbrella policy paid. He will be responsible for the remaining $200,000. If the policy owner fails to maintain the required underlying coverage, the insurer will pay only the amount it would have been required to pay had the underlying policies provided the appropriate limits.
4. Mr. and Mrs. Malibu live in California, a community property state. They are both movie actors. They also own a condo in New York. They insure the condo under an HO-6 with $300,000 of liability protection. What do you suggest they do with liability exposures relative to the condominium?
   A. Nothing - Community property interests are automatically protected from civil suits because of the one-half interest requirement.
   B. Buy an umbrella policy with at least $1,000,000 BI/PD
   C. Change the HO-6 to an HO-3 to afford them more protection

   Answer:   B $300,000 in personal liability coverage is not enough. They should acquire the umbrella liability coverage. Answer A is nonsense. Condominiums are covered by HO-6 policies but not by HO-3 policies.

B. Business

1) Commercial property insurance

Business owner’s policy (BOP)
The business owner’s policy is for small-to-medium-size businesses. The normal policy is a package that provides real property, contents, and liability protection. Professional liability is specifically excluded. The premium is deductible to the business.

Applying the Facts

1. Fifi owns Hair Today beauty salon. She wanted the windows to be washed. While on a ladder cleaning the windows, employee Stanley stylist dropped a bucket with water on Mrs. Customer as she was entering the salon. Fifi's business should be protected from any liability, property damage, or medical payments by which policy?
   A. Workers' compensation  C. Commercial umbrella
   B. BOP D. E & O liability

   Answer:   B A business owner’s policy provides liability protection, property damage, and medical payment coverage. The umbrella coverage only takes effect after the limits of the BOP are exhausted.

2. Ron, a registered securities principal, is concerned about being sued. He supervises four registered representatives in his branch office. Which policy(s) should he purchase?
   I. A personal umbrella policy IV. An E&O policy
   II. A malpractice policy V. A commercial policy
   III. A business owner’s policy

   A. All of the above D. III and IV
   B. I, II, IV E. IV, V
   C. I, III, IV

   Answer:   D III and IV

   Ron should purchase a malpractice policy (II) and an E&O policy (IV) to protect himself as a registered securities principal.
Answer: C  Ron can be sued for more than errors and omissions. He needs a personal umbrella policy for his non-business exposures and a business owner’s policy. It is his office. He also needs E&O (Error and Omissions) coverage for his professional activities.

**Personal property floater**
A personal property floater is similar to the scheduled personal endorsement discussed earlier in this lesson. This floater is designed primarily to provide "open perils" coverage for unscheduled personal property on a worldwide basis.

**Usage - for excess personal property not covered**
A personal articles floater is appropriate for the person without a homeowner's policy, the person whose homeowner’s policy will not cover a certain item(s), or the value of coverage needed is beyond the homeowner's policy limits. The coverage is for property that moves around (floats) like cameras, jewelry, sporting equipment, etc.

**2) Commercial umbrella policy**
Most umbrella policies exclude any error, omission, malpractice, or mistake of a professional. The premium is deductible.

**3) Professional liability**
Professional liability insurance covers liability arising from the failure to use due care and the degree of skill expected from a person in the profession in which the insured is engaged. The test question, if any, may only involve the difference between "malpractice" insurance and "errors and omissions" insurance. The premium is deductible. "Malpractice insurance" generally is appropriate where the substandard conduct may result in bodily injury, for example for physicians or dentists.

"Errors and omissions insurance" generally is appropriate where the substandard conduct may result in property damage. Such situations include damage to intangible property, such as loss of money. Professionals who should carry errors and omissions insurance include lawyers, insurance agents, stockbrokers, and financial planners.

**Example**
Penny Planner, CFP® has been sued for giving poor stock market advice. She has $1,000,000 of E&O and $1,000,000 of liability coverage under her commercial policy (BOP). Will either policy provide protection with regard to the stock market advice lawsuit? Yes, only the E&O will provide protection. Professional liability is excluded under the BOP.

**4) Directors and officers errors and omissions insurance**
This insurance protects corporate officers and directors from suits alleging mismanagement. Such suits may be brought by stockholders or other persons.

**5) Workers’ compensation**
Workers' compensation reflects absolute liability. It is an exception to the rule that there can be no liability without fault. Most workers' compensation laws are compulsory for employers. The full cost of providing workers' compensation benefits must be borne by the employer. The employer can deduct the premium cost. Owners of businesses are generally not covered under workers compensation.
Benefits Under Workers Compensation
- Medical expenses without limit on time or money, including occupational disease benefits. They are not subject to any deductibles or coinsurance.
- Disability income with very short waiting periods (days). Benefits are for both total and partial disabilities. Benefits are a percentage (usually 66 2/3 %) of the employee's average weekly pay subject to maximum and minimum amounts.
- Death benefits are payable to family members.
- Rehabilitation benefits include medical rehabilitation as well as vocational rehabilitation.

Taxation
Workers' compensation benefits are received income tax free. Although the employer may deduct the premium cost, that remains true.

Applying the Facts
1. Workers' compensation is an example of which of the following?
   A. Vicarious liability
   B. Strict liability
   C. Absolute liability
   D. Socialism in the workplace

   Answer: C Workers’ compensation reflects absolute liability.

2. Bill is injured at work. The injury is serious and could result in death or disability. Which of the following benefits will be available to Bill under his employer's Workers' Compensation insurance?
   I. Sick-leave benefits (taxable)
   II. Disability benefits (tax free)
   III. Rehabilitation (tax free)
   IV. Survivor's death benefit (tax free)
   V. Medical expense (no limit)

   A. All of the above
   B. I, II, III, V
   C. II, III, IV, V
   D. II, IV

   Answer: C Sick-leave benefits are not provided under Workers' Compensation. Rehabilitation and various Disability benefits are provided tax-free under Workers’ Compensation.

6) Unemployment insurance
Benefits are determined by previous earnings, payable up to 26 weeks (plus a 13 week extension in high unemployment periods). Unemployment insurance benefits are normally included in a recipient's gross income (taxable).
Continuing from Applying the Facts #1 on previous page –

After John dropped the bucket, he slipped and fell off the ladder. During the 3 months he was unable to work, he received $3,000 in workers' compensation payments, $14,800 from insurance reimbursing him for his medical expenses, and $3,500 from the group disability plan. After his recovery, he decided not to return to work, and he is now collecting $1,000 per month of unemployment compensation. Which items must he recognize as taxable income?

A. None of the above is taxable income due to the cause of disability.
B. Only the disability benefits are taxable income.
C. Only the reimbursement of medical expenses is tax-free.
D. Both the sick pay (disability benefits) and unemployment compensation are taxable income.
E. Only the unemployment compensation is taxable income to John.

Answer: D  Reimbursement of medical expenses and disability under workers' compensation is tax-free. The group disability payments are taxable because group disability insurance premiums are generally paid by the employer. The only exception occurs when the employee is contributing (contributory plan). Then the benefits are fully or partially tax-free. Unemployment compensation is taxable.

Applying the Facts

1. Which of the following benefits would be paid to an employee tax-free?
   A. Workers’ Compensation disability benefits
   B. Sick pay benefits
   C. Unemployment benefits
   D. Vacation pay

Answer: A  Sick pay is a disability insurance benefit. It is taxable. Unemployment insurance benefits and vacation pay is generally taxable.
2. Mark Meyers has an HO-3 policy with an HO-15 endorsement. Which of the following among Mark’s family members would be covered for personal liability under that policy?

A. Mark’s son, Luke, age 30 who lives full-time with his father.
B. Mark’s daughter, Michelle, age 28, who along with husband, Quentin, age 29 lives in a separate apartment within Mark’s home.
C. Mark’s daughter, Linda, age 19, who is a full-time college student. Linda generally lives with her mother but regularly visits in Mark’s home on an overnight.
D. Mark’s mother, Emily, age 87. Until four months ago, Emily lived with Mark. She now lives at the Restful Sunshine Home.

Answer: A Luke “lives” in the residence with his father. Answer B is debatable because it does not state clearly whether they are renting the apartment or not. Answers C and D are definitely not covered.

3. Mr. Wilks, married, needs to build a separate dwelling on his property for his mother. It will cost $75,000. How can the property be covered (when completed) if he has a HO-5 with $500,000 of Coverage A?

A. Under an HO-4 policy
B. Under his own HO-5 policy by increasing the “B” percentage
C. It will not be covered under “other structures” due to its usage.
D. The percentage of Coverage A for Coverage B will not be enough (only 10% of A).

Answer: B If the 10% standard Coverage B for unattached structures are not adequate, it may generally be increased. Answer D is true, but does not answer the question.

4. Mr. Boyd owns Boyd, Inc. The company carries various business insurance policies. Premiums for which of the following business policies are tax-deductible by Boyd, Inc.?

I. Workers’ Compensation insurance
II. Unemployment insurance
III. Commercial umbrella insurance
IV. A BOP policy

A. I, II, III, IV  D. II, III
B. I, III  E. II, IV
C. I, IV
Answer: A All the policy premiums create a tax deduction to the business. They all represent necessary business expenses.

NOTE: FUTA is the unemployment tax the business pays to the Federal government. Boyd, Inc. also pays unemployment tax to the state. Employer-paid FUTA is deductible.
Health Insurance

Lesson 4

Health insurance and health care cost management (individual)

A. Comprehensive major medical plan – Stop-loss (coinsurance)

Less common today.

1st The insured pays a calendar-year deductible ($250 or more, for example).

2nd The insurance carrier pays a calendar-year coinsurance (normally 80%), and the insured pays a remainder (normally 20%) of the next medical expenses.

3rd After a client pays his/her portion of the stop-loss limits (also called a breakpoint), the company pays 100%.

Applying the Facts

1. Lucy has an unlimited major medical policy with a $500 deductible and 50%/50% coinsurance provision to a $10,000 stop-loss limit. Recently, she was hospitalized and incurred medical expenses of $7,500. What amount must the insurer pay in this situation?
   - A. $4,000
   - B. $3,500
   - C. $3,250
   - D. $4,250

   Answer: B 

   Total claims $7,500  

   **NOTE: under stop-loss limit**

<table>
<thead>
<tr>
<th>Lucy</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deductible</td>
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</tr>
<tr>
<td>Stop-loss</td>
<td>$3,500</td>
</tr>
<tr>
<td>+</td>
<td>$4,000</td>
</tr>
</tbody>
</table>

2. Todd has an unlimited major medical insurance policy with a $350 deductible and 80%/20% coinsurance to a $5,000 stop-loss. Todd had a claim of $10,000. What amount must he pay out-of-pocket?
   - A. $1,000
   - B. $1,350
   - C. $4,000
   - D. $4,650
   - E. $8,650

   Answer: B

   Total claim $10,000

   - Deductible: $350
   - Stop-loss: $10,000
   - Coinsurance: 80% of ($10,000 - $350) = $7,800
   - Total: $350 + $7,800 = $8,150

   Todd pays $8,150 out-of-pocket.
3. Comprehensive major medical coverage for Ben, Sally, and children

$500 deductible / 3 deductibles per family maximum
80%/20% of next $5,000 (coinsurance) / 100% thereafter

Ben and Sally have the following claims due to an accident:
Ben $9,000    Son $10,000
Sally $8,000    Daughter $7,000

What will the insurance coverage pay?
A. $25,000   C. $28,000  E. $32,500
B. $25,500   D. $28,500

Answer: D When the total amount of the claim is the stop-loss plus deductible limit, then the easiest way is to calculate how much Ben and Sally are responsible for is the following.

3 deductibles $1,500
4 coinsurances ($1,000) 4,000

Then, subtract $5,500 from $34,000 (total claims) to get the amount the insurance company will pay.

B. Continuance and portability
The Affordable Care Act requires medical expense insurers to continue coverage regardless of claims as long as the insured pays the premium(s). With many policies, the premium can and will increase on renewal.

NOTE: COBRA and HIPAA are covered later in the material - Group health insurance.

C. Medicare
Traditional Medicare consists of Hospital Insurance protection (Part A) and Medical Insurance protection (Part B).

Hospital Insurance: Part A

Eligible persons
All persons age 65 and over who are entitled to (not necessarily receiving) monthly Social Security cash benefits or monthly benefits under Railroad Retirement programs (whether retired or not) are eligible for benefits.

Regardless of age, disabled beneficiaries receiving benefits for at least two years (no age requirement) are eligible for benefits. A Social Security disability beneficiary is covered under Medicare after entitlement to disability benefits for 24 months or more. Those covered include disabled workers at any age, disabled widows and widowers (of workers)
age 50 or over, beneficiaries age 18 or older who receive benefits because of disability beginning before age 22, and disabled qualified railroad retirement annuitants.

NOTE: Such disabled individuals automatically receive Part A and Part B coverage

Benefits from Part A
a. Hospital stays - Subject to a deductible for the first 60 days, then a second deductible for the next 30 days, and third deductible for another 60 days. Inpatient hospital care is limited to 150 days for one stay.
b. Post-hospital extended care in a skilled nursing home. Up to 100 days (see Lesson 5)
c. An unlimited number of post-hospital home health services
d. Hospice care for terminally ill patients
e. Patient pays for 1st 3 pints of blood or donates them. Medicare A covers additional blood.

Limitations
Generally, services outside the U.S. are not covered. However, under limited circumstances, services furnished in Canada, Mexico, the Caribbean, or aboard ships in U.S. territorial waters may be paid by hospital insurance. Services provided outside the United States are not covered. When a person is covered by an employer group health insurance plan, is entitled to veteran’s benefits, or is covered by workers' compensation, Medicare is the secondary payor.

Medical Insurance: Part B
Part B is voluntary. The same persons eligible under Part A are also eligible under Part B. Part B is financed through monthly premiums paid by those who enroll plus contributions from the federal government. The patient pays a deductible first. Medicare pays 80% of the balance of the approved charges. No stop-loss applies, leaving the client with significant financial exposure (20% of an unlimited amount).

Benefits from Part B
a. Doctor's services including house calls, office visits, and doctor's services in a hospital or other institution (i.e. nursing home).
b. Also covered are
   – Diagnostic tests
   – Radiology/pathology
   – Treatment for mental illness (limited)
   – Drugs and biologicals that cannot be self-administered
c. Outpatient services from a participating hospital for diagnosis or treatment
d. An unlimited number of home health services (same as Part A)
e. Free preventive care services like colorectal cancer screening and mammograms. Participants will also receive a free annual wellness checkup to develop and update their personal preventive plan based on current health needs.

Excluded from Part B
– Routine dentures and dental care
– Exams for eyeglasses or hearing aids
– Most immunizations (does cover one free flu shot per year)
– Prescription drugs (see above and next page)
Applying the Facts
Which of the following is a benefit provided by Medicare B?
A. Coverage for prescription drugs that can be self-administered
B. Coverage for skilled nursing home up to 100 days
C. Free preventive care services
D. Hospital care beyond 150 days of one stay

Answer:  C Routine preventive care exams (wellness exams) are free. Medicare B coverage for prescription drugs is limited to drugs which cannot be self-administered. Skilled nursing home stay and the hospital stay are Medicare A coverages not a Medicare B coverage.

Medicare Part D
One must join a plan run by an insurance company approved by Medicare. Drug manufacturers must generally provide a 50% discount. To get Part D, the person must have Medicare Part A and/or Part B. Beneficiaries who are already receiving Medicaid benefits will receive prescription drug coverage through Medicare. NOTE: The donut hole numbers are not tested.

Medicare Supplemental (Medigap) policy
Medicare imposes various deductibles and generally pays for only 80% of covered physician charges. Ten standard Medicare supplement plans (Plan A to Plan J) are available in most states. Medigap policies include benefits to pay deductibles and coinsurance etc. but also add benefits not included in Medicare. To prevent overselling, retirees may be sold only one Medicare supplement policy (at a time). Medigap policies offering prescription drug coverage are no longer issued.

Applying the Facts
1. Abel Aboutoretire is turning 65. He will be covered under Medicare A but not by Medicare B. Can he buy a Medigap policy?
A. No, the gap is too large.
B. Yes, but it will only cover him for Medicare A.
C. Yes, it will completely cover him for Medicare A but will only partially pay under the B portion.
D. No

Answer:  D Medigap policies are available only to individuals currently enrolled in both Medicare Part A and Part B. Persons age 65 or older may buy any available Medicare supplement policy at any time during the 6-month period after initial enrollment for Medicare B benefits.
2. Which type of prescription drugs shown below is not covered by Medicare Part B?
   A. Certain oral cancer drugs
   B. Injections at a doctor’s office
   C. Self-administered drugs
   D. Drugs used with types of durable medical equipment

   Answer: C  Self-administered drugs are generally not covered under Medicare Part B.

**Group medical insurance**

**A. Types and basic provisions**

**a. Health maintenance organizations (HMOs)**

An HMO provides a wide range of comprehensive health care services to a group of subscribers in return for payment and delivery features for a fixed premium.

- **Capitation** - A monthly fee is paid to the provider. In return, the individual receives virtually all the medical care required during the year.
- **Gatekeeper** - Care is managed by a primary care physician who is responsible for determining what care is provided and when the individual should be referred to specialists.

**Major disadvantage to HMO’s**

Besides having to go through a gatekeeper, the subscriber is not covered when he/she uses a provider other than the HMO (unless for an emergency). Subscribers are required to obtain their care from providers who are affiliated with the HMO.

NOTE: Children can remain covered on their parent’s employers’ policies until age 26.

**b. Preferred provider organizations (PPOs)**

PPOs represent a group of healthcare providers contracting with insurance companies, third party administrators, or others to provide medical care services at a reduced fee. PPOs differ from HMOs in two major respects.

- Health care providers in the PPO are generally paid on a fee-for-service basis as needed.
- Employees are not required to use practitioners or facilities of the PPO. They can go outside of the network, but benefits are generally reduced relative to benefits paid for network provided care. Thus deductibles will be higher.

**Applying the Facts**

Which of the following is not true regarding employee group health insurance?

A. Covered employees may use PPO physicians or go outside the Network under a PPO plan.
B. Employees must see the HMO gatekeeper first under an HMO plan.
C. HMOs emphasize cost containment.
D. HMOs pay a fixed monthly fee to providers.
E. PPOs provide medical care on a prepaid basis.

Answer: E  PPOs provide medical care on a fee-for-service basis.
B. Income tax implications
Premiums for employees’ and employee's dependents' coverage are tax-deductible by the employer. Employer premium contributions do not create income tax liability for an employee. Unlike individual coverage, benefits are taxable if they exceed any medical expense incurred. Self-employed persons, partners, and more than 2% shareholder-employees of an S corporation may be eligible to deduct certain health insurance premiums above the line. NOTE: For some larger corporations, health care cost now needs to be reported on the employees’ Form W-2. However, it is not taxable income.

C. Employee benefit analysis and applications
A thorough comparison should be undertaken to determine which plan is suitable.

D. COBRA/HIPAA provisions
Under the Consolidated Omnibus Budget Reconciliation Act (COBRA), employers providing group or self-funded health coverage are required to offer terminated employees the right to buy continued health coverage (identical coverage). Small companies (fewer than 20 employees for at least half of the prior year) are also exempt from the federal legislation.

Plan coverage
Group health plans for employers with 20 or more employees (or the equivalent) on more than 50% of its typical business days in the previous calendar year are subject to COBRA. Both full and part-time employees are counted to determine whether a plan is subject to COBRA. Each part-time employee counts as a fraction of an employee, with the fraction equal to the number of hours that the part-time employee worked divided by the number of hours that an employee must work to be considered full time.

Coverage must be offered to "qualifying event":

- terminated employees & other dependents voluntary or involuntary termination
- continuation period – up to 18 months change from full-time to part-time
- spouses & other dependents employee's death, divorce, legal
- continuation period – up to 36 months separation, or eligibility for Medicare
- children of employees loss of dependent status (marriage, reaching dependency age limit specified by plan)
- continuation period – up to 36 months

NOTE: A disability qualifying event is 29 months.

Examples

Peter and his family are covered under his employer’s health plan (more than 20 employees). If he dies and his wife elects coverage, how long will his family's benefits continue under COBRA?

Answer: 36 months because the employee's death is the qualifying event

Peter and his family are covered under the company’s health plan (more than 20 employees). If the company terminates his employment, how long will he and his family be able to continue benefits under COBRA?

Answer: 18 months because termination is the qualifying event
If Peter dies 16 months after electing COBRA coverage as a result of his termination (from example directly above), how long will his wife and children’s benefits last?

Answer: 20 months Why not just 2 months?

Two circumstances can extend the initial 18-month period of continuation coverage.
– If either the employee or a covered family member is disabled (based on Social Security Administration determination) within 60 days of the triggering event, the period of continuation coverage can be extended by 11 months (for a total of 29 months).
– The second circumstance occurs only when one of the following qualifying events occur.
  - death of a covered employee
  - divorce or legal separation of a covered employee and spouse
  - covered employee becomes eligible for Medicare
  - loss of dependent child status under the plan
Any of these events can extend the initial 18-month period by another 18 months (for a total of 36 months from the first triggering event).

Continuation of coverage is not automatic; it must be elected. The election period starts on the date of the qualifying event and may not end earlier than 60 days after the actual notice of the event to the qualifying beneficiary by the plan administrator. Once the coverage is elected, the beneficiary has up to 45 days to pay the premium for the period of coverage prior to the election. Under COBRA, the cost of continued coverage may be passed on to the qualifying beneficiary, but the cost cannot exceed 102 percent of the cost of the plan for the period of coverage for a similarly situated active employee to whom a qualifying event has not occurred.

Should the client carry Medicare-Part B?

Employer or Union Coverage – If you or your spouse (or family member if you’re disabled) is still working and you have coverage through an employer or union, it may be wise to delay Part B enrollment. When the employment ends, three possibilities occur:

1. Elect COBRA coverage, which continues health insurance coverage through the employer’s plan (in most cases for only 18 months) and probably at a higher cost to you.
2. Within 8 months sign up for Part B without penalty. If one enrolls in Part B after the 8 months, you may have to pay an increased premium.
3. Upon signing up for Part B, your Medigap open enrollment period begins.

Applying the Facts
1. Steve is married with two children. Steve works for TTI, Inc. TTI has 50 employees. The company offers an HMO plan. If Steve divorces his wife, presuming he has family coverage under the HMO, which of the statements below is correct?
   I. He will get 18 months of COBRA coverage.
   II. His wife will get 18 months of COBRA coverage.
   III. His wife will get 36 months of COBRA coverage.
   IV. His children will get 36 months of COBRA coverage.
   V. There is no COBRA under an HMO plan.

   A. I, II, IV    C. III, IV
   B. II          D. III

   E. V
Answer: D Through this employer-provided HMO plan, Steve’s ex-wife gets 36 months of continued coverage. He did not divorce his children. They are still covered under his family coverage.

2. Most business days, ABC company employs 12 full-time workers and 16 part-time employees (50% of its business days). If Alice, a full-time participating employee quits in order to take a job with a competitor of ABC, will she be covered under COBRA?
A. Yes, because the company has more than 20 employees. Coverage will continue for 18 months.
B. Yes, because the company has more than 20 employees. Coverage will continue for 36 months.
C. No, because the company has less than 20 employees.
D. No, because more than half of the total employees must be full-time employees.

Answer: A An employer is considered to have employed fewer than 20 employees during a calendar year if it had fewer than 20 employees on at least 50% of its typical business days. Independent contractors, agents, and directors may also be included only if they participate in the group health plan.

3. Mrs. Steel's husband died unexpectedly. Mr. Steel was employed by a large insurance company. He was enrolled (family coverage) in the company's medical plan. Mrs. Steel and her children will be eligible for which of the following?
A. No continuation of medical coverage
B. Mrs. Steel gets 36 months of continuation coverage.
C. All qualified family members receive 36 months of continuation coverage.
D. Mrs. Steel and her children receive 36 months of coverage after a 60-day wait.

Answer: C The triggering event is death.
4. Joan works for ABC, Inc. which operates a self-insured employee benefit health plan covering only eighteen employees (total employees: twenty-five). She is a covered employee (family coverage). If Joan terminates employment, which of the following is true?

I. Joan can continue coverage for up to eighteen (18) months.
II. Joan's spouse and dependents have coverage for up to thirty-six (36) months.
III. If Joan waits to elect coverage for up to sixty (60) days, no premium is due for the election period.
IV. Joan's premium costs can be as high as 125% of the cost of normal group coverage.
V. The plan must be identical to coverage still provided by the health plan to remaining employees.

A. All the above D. I, V
B. I, II, III, V E. None of the above is true.
C. I, II, IV

Answer: D The triggering event is termination. Thus (only) eighteen months of COBRA continuation is available. Answer II is only true if the employee dies or divorces or separates from a spouse. Then COBRA coverage is available. For a dependent, COBRA coverage is loss of dependent status. Joan’s spouse and dependents have coverage for up to 18 months. Premiums are due retroactive to the termination date and only 2% can be added by the employer to the normal premium cost to cover its administrative costs.

5. Tommy and Gayle have been married for 30 years. Tommy is employed by Blue Cab Company. The company has 40 total employees; 18 work full-time, and 22 work part-time. Tommy, a full-time employee, is covered under the company’s group health insurance program with Gayle as a dependent spouse. Gayle is divorcing Tommy. If she elects COBRA after the divorce, how long will her benefits last?

A. No COBRA will be offered; the company doesn’t have more than 20 full-time employees.
B. 18 months
C. 36 months
D. Not enough information is known to answer the question.

Answer: C The triggering event is divorce resulting in 36 months of continuation. The part-time employees count toward the 20-employee rule. The plan will provide COBRA to a covered employee’s spouse.
E. Employer’s Insurance
No child under age 19 can be denied coverage because of pre-existing medical conditions. (Affordable Care Act)

F. Saving accounts
1) Health saving accounts (HSAs) - 2020
Contributions by an individual are deductible for federal income tax purposes even if the individual does not itemize deductions. It is an adjustment to income on the front of the 1040. Adjustments to income are deductions for AGI or above-the-line deductions.

Employer contributions are deductible by the employer and do not represent taxable income to an employee.

<table>
<thead>
<tr>
<th>Contribution source</th>
<th>Health Savings Accounts (HSAs)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Individual (or by a family member on behalf of the individual) and/or employer</td>
</tr>
<tr>
<td>Tax-deductible contribution</td>
<td>Up to 100% of deductible with a maximum cap determined by the IRS Single coverage: $3,550; family coverage: $7,100</td>
</tr>
<tr>
<td>Deductible ranges</td>
<td>Minimums: $1,400 for single; $2,800 for family</td>
</tr>
<tr>
<td>Maximum out-of-pocket</td>
<td>Maximums: $6,900 for single; $13,800 for family</td>
</tr>
<tr>
<td>Who is eligible?</td>
<td>Individual must be covered under a qualified high-deductible health plan, below Medicare eligibility age, and not covered under any other health plan.</td>
</tr>
<tr>
<td>Catch-up provisions</td>
<td>Individuals age 55 or over may contribute an additional $1,000 (2020) It has been increasing yearly.</td>
</tr>
<tr>
<td>Effective date</td>
<td>January 1, 2004</td>
</tr>
<tr>
<td>Do employers need to make comparable contributions?</td>
<td>Yes – both employers and employees can contribute.</td>
</tr>
</tbody>
</table>

NOTE: HSAs are savings accounts that operate alongside a High Deductible Health Plan (HDHP).

An Insurance Policy and Special Savings Account
A Health Savings Account is a combination of a health insurance policy meeting minimum US Treasury policy design requirements for a High Deductible Plan (HDHP) and a separate custodial savings account for future medical expenses called a Health Savings Account (HSA). A health insurance company or an insurance plan usually provides the qualified health insurance policy. A licensed HSA administrator and financial services company, such as a bank, acts as the custodian and administers the savings portion of the HSA.

HSA Design Requirements
A qualified HSA plan usually has a single annual deductible that applies to all medical expenses covered by the insurance policy whether you are insuring yourself or an entire family. Some plans may be available with separate individual deductibles. This deductible must be satisfied each year.
Applying the Facts
Which of the following is false about HSA contribution rules?
A. Contributions can be made by either the employer, the individual, or both.
B. Contributions made by the employer are tax-deductible and not taxable to the individual.
C. Contributions made by the individual are an above-the-line tax deduction.
D. Contributions are not aggregated between employer and employee.

Answer: D Aggregated means contributions from the employee and employer are combined.

Features of HSA’s:
- Distributions can be for health care needs not covered by the high-deductible policy and are tax-free.
- Penalties for nonmedical HSA withdrawals are now 20% of the distribution if under age 65.
- Over-the-counter OTC drugs will no longer qualify as a medical expense except for insulin.
- Money in the accounts can be used to pay for retiree health insurance premiums with no minimum deductible requirements as well as for prescription drugs and COBRA and qualified LTC premiums.
- Preventive care services are not subject to the deductible.
- Contributions not spent on health care can be carried forward for the lifetime of the individual and can be transferred upon death to a spouse tax-free.
  Unused assets in an HSA become the property of a named beneficiary upon the account-holder's death, or if no beneficiary is named, the assets go to the decedent’s estate. A spousal beneficiary can treat the assets as his/her own account while a non-spouse beneficiary must include the assets as ordinary income for taxation purposes.
- Employees are allowed a once-in-a lifetime rollover from their IRA into a HSA. The election is irrevocable. The change is designed to give access to IRA balances for medical expenses.

Examples of HSA Qualified Expenses
- Doctor visits and tests not covered by the insurance policy.
- Surgical procedures and hospitalization related charges not covered by the insurance.
- Prescription drugs
- Certain OTC drugs qualify but now need a prescription from your doctor
- Acupuncture & chiropractic care
- Eye exams, glasses and laser surgery
- Hearing test and hearing aids
- Dental exams, dental work and dentures
- Alcohol and drug abuse treatment
- Insulin and diabetic testing supplies
- Long term care related expenses
- Vitamins and supplements do not qualify

2) Archer Medical Savings Accounts (MSAs)
MSAs were the frontrunner for HSAs. No new MSAs may be established after 12/31/05.

Distributions from HSAs and MSAs
Distributions are excludible from an account holder's gross income if they are used to pay eligible medical expenses of the account holder (or family) as long as these expenses are not paid or reimbursed by the high-deductible insurance plan.
Example
Sally has an HSA plan with a $2,200 deductible. If she incurs $2,600 of medical expenses, what will be her tax? The HSA trustee will reimburse the $2,200 out of the HSA account tax-free, and the insurance will reimburse the remaining $400 tax-free.

Applying the Facts
1. Which of the following are true about HSA distributions?
   I. HSA distributions can be used to pay the premiums for qualified long-term care insurance.
   II. HSA distributions not used for qualified medical expenses are subject to 20% penalty unless the individual dies, is disabled, or reaches the age of Medicare eligibility.
   III. Money left in an HSA account at age 65 (or older) can be withdrawn tax-free for any purpose without penalty.
   IV. HSA distributions taken to pay qualified medical expenses are tax-free.
   A. I, II, IV  
   B. I, III, IV  
   C. II, IV  
   D. III, IV

Answer: A  Money remaining in an HSA account at age 65 or older that is withdrawn for a purpose other than health care is taxed at ordinary income tax rates. However, there is no 20% penalty when the insured reaches the age of Medicare eligibility.

HSA distributions can only be tax-free when used to pay for the following types of premiums:
- COBRA continuation coverage
- Health plan coverage while receiving unemployment compensation
- For individuals eligible for Medicare
  - Medicare premiums and out-of-pocket expenses (Part A, Part B, Medicare HMOs, new prescription drug coverage)
  - Employee share premiums for employer-based coverage
- Qualified long-term care insurance

NOTE: HSA distributions for Medigap premiums are not income-tax free.

2. Inez Insured maintains an HSA with a $2,200 deductible. She recently made a medical claim for $3,000. The insurance carrier reimbursed $800. She took a $2,200 distribution from her HSA for the remaining $2,200 of medical expenses. Is the distribution taxable?
   A. No amount is taxable.
   B. 65% is taxable; 35% is tax-free.
   C. 35% is taxable; 65% is tax-free.
   D. 100% is taxable.

Answer: A  Distributions used for qualified medical expenses are received tax-free.
3. HSA funds can be used to cover additional expenses that generally are not covered by a health insurance policy. Which of the following are permitted?
   I. Dental expenses
   II. Psychiatric visits
   III. Physical therapy
   IV. Acupuncture
   V. Non-prescription cough syrup

   A. All the above
   B. I, II, III, IV
   C. I, II, III
   D. II
   E. III

   Answer: B  HSAs can cover all the listed expenses (as well as maternity expenses) not covered by a health insurance policy. Tax-free distribution can come from HSAs to pay premiums for qualified long-term care insurance. Over-the-counter drugs no longer qualify as an eligible medical expense.

3) Health reimbursement arrangements (HRAs)
   An HRA is an arrangement that
   – is solely employer-funded and
   – reimburses employees for substantiated medical expenses up to a maximum dollar amount per coverage period. Example: It can reimburse for out-of-pocket costs of an HDHP (High Deductible Health Plan).

   NOTE: HRAs will not reimburse for non-prescribed over-the-counter drugs.

Applying the Facts
1. Can an HRA be part of a cafeteria plan?

   Answer: No. It is solely employer-funded. It may not be attributed to salary reductions.

2. Are reimbursed amounts excludible from employee gross income?

   Answer: Yes

3. Can an HRA offer a cash-out option at any time?

   Answer: No, it cannot (even at termination of employment).

4. Can an HRA reimburse expenses after employment?

   Answer: Yes, it can whether or not the employee elects COBRA.

5. Can an employee be reimbursed for the same expense by both an HRA and an FSA? No. Only one plan can be used at one time. The HRA reimbursement money will come out before the FSA money can be used. What happens to the unused money in the HRA?

   Answer: The employer retains any excess.
NOTE: Group Health Conversion Plan
Conversion may only be available if available under the Group Policy.

Under certain circumstances which vary among the states, a terminating employee may exercise the conversion privilege to purchase a conversion plan for health insurance. In regard to health insurance, the notification should be made immediately after the termination or, if COBRA is elected within 180 days before the end of the 18-, 29-, or 36-month Continuation Period. 29 months comes from an additional 11 months of coverage if the insured becomes disabled.

The Employer should inform the terminating employee and/or any dependents that may be losing coverage of any available options.

NOTE: Application for conversion must be made on or before health insurance under the group plan ends.

How to convert: The employee must submit an application and pay the initial premium within 31 days of the date the group insurance ends.

Applying the Facts:
Mr. Fitt, age 55, is single and in good health. He has never been married. He is an executive with a medium-sized company. The company provides a 401(k). He has been deferring the maximum and the company matches at 6% plus an occasional profit-sharing contribution. In addition to this plan he has saved and invested. He plans to retire around 62 but before his full retirement age. Which of his employee benefits would you counsel him to continue?

A. His group disability (30% of his salary)
B. His PPO plan
C. His group life insurance (2x salary)
D. His 401(k)

Answer: B He should continue his PPO coverage for as long as he can following his voluntary termination due to retirement. He will not be able to convert his disability and it does not matter. He will be retired. Disability only replaces earned income. The life insurance could be converted, but why? He is single, never married. His problem is he will have more than 18 months from retirement to Medicare eligibility. He may be able to convert or maybe he should work until 63½. The 401(k) is not an issue.
Disability income insurance / Long-term care insurance

Lesson 5

Disability income insurance (individual)

A. Definition of total disability

In terms of its negative financial effect, long-term disability is more severe than death.

The best definition of total disability for the benefits is "the inability of the insured to engage in his or her own occupation."

The next definition of total disability makes it harder to claim benefits. The insured is unable to engage in any occupation for which he/she is qualified by reason of training, education, or experience. This is modified any-occupation (or may be called modified own-occupation).

NOTE: Certain policies use the first definition (own) and the second definition (modified any). This is a dual definition or split definition. For example, for 2 – 10 years the definition may be own; thereafter, for the remainder of the contract, the definition may be modified any occupation.

<table>
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<tr>
<th>2-10 years</th>
<th>to age 65</th>
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<tbody>
<tr>
<td>own</td>
<td>modified any-occupation</td>
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</table>

The next definition reflects the Social Security rules. The insured is deemed totally disabled if unable to engage in any substantial gainful activity by reason of any medically determined physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.

The loss of income definition abandons the effort to define disability. This policy pays benefits based on economic loss following a physical disability event. Partial disability is covered.

Example

Jack makes $120,000 per year. He is covered under a loss of income policy with $6,000 per month limit. Due to a partial disability, his income drops to $60,000 per year. He will receive a $3,000 per month disability benefit. This is based on a 50% reduction in his income.

Applying the Facts

I. Your client, a trial attorney, lost his voice a year ago. He now works for a law firm doing trial research only. He is upset because his disability insurance company won't pay benefits. After you review his policy, what is your conclusion?

A. He is covered under an own occupation policy.
B. He is covered under a dual definition policy.
C. He is covered under a loss of income policy.
D. He is covered under an any-occupation policy.

Answer: D Answer D is true because he is still practicing as an attorney.
2. The prior question continues. The trial attorney had been making $240,000 a year and has covered under a disability policy with a total disability benefit of $10,000 per month. Due to voice problems, his practice was suffering. Prior to losing his voice, his income had decreased by approximately one-half to around $120,000 over the last year. Since losing his voice, the attorney’s firm has been paying him $15,000 per month to perform research. The insurance company has denied his claim. After you review his policy, what is your conclusion?

A. His policy uses the own occupation definition of total disability.
B. He has a loss of income policy.

Answer: B

With a loss of income type disability insurance policy, the disability insurer will review his earning history for the prior 2 years. The benefit of $10,000 per month is equal to his earnings at the time he lost his voice ($120,000). The carrier may not pay $10,000 per month (100% of his earnings).

Continuance provisions (also found in individual medical and long-term care insurance)
Noncancelable ("noncan") disability contracts guarantee that the individual can keep the policy in force by paying the stated premium and that the premium will not increase (normally renewable to age 65 or at normal retirement age).

Guaranteed renewable disability contracts guarantee that the individual can keep the policy in force by paying the premium, but the premium may be increased on a class basis, not on an individual basis (normally renewable to age 65). One would buy a guaranteed renewable policy rather than a non-cancelable policy to get lower premiums now for the same benefits. However, the premium would not be guaranteed for the life of the contract and likely will increase.

Conditionally renewable allows a noncancelable or guaranteed renewable policy to continue beyond age 65. The policy usually only has a 2-year benefit, and the premium is adjusted for benefits and age. It can only be extended if the insured is still an active employee.

Applying the Facts
1. Dr. Ted Swan bought a guaranteed renewable policy at age 35. Now 20 years later, the carrier doubled his premium. What are his options?

A. To pay the original premium
B. To lapse the policy
C. To buy a new policy at a cheaper premium

Answer: B

Under guaranteed renewability, Dr. Ted's only choice (other than to cancel the policy) is to pay the current higher (not original) premium. A new policy would also entail higher premiums. New policy premiums are age sensitive, and he is 20 years older than when he acquired the original disability coverage. The new policy premium would likely be more than double the existing policy premium.
2. Norman Numbers, a CPA, went through a financial slump in his 60s. Now at 65, his disability policy is about to expire. Unfortunately, he still needs disability coverage. What are his options?
   A. None
   B. Buy a new policy
   C. Exercise his conditionally renewable provision
   D. Sue his agent

Answer: C He should be able to extend coverage beyond age 65 (conditionally renewable provision).

**B. Benefit period**
Policies written today pay benefits to age 65+ but can have a shorter duration of benefits (2-5 years). Disability income insurance policies no longer offer lifetime coverage.

**C. Elimination period (waiting period)**
The waiting period acts like a deductible. The longer the waiting period, the lower the premium. Waiting periods up to 2 years are available. Older policies were typically written with waiting periods of 30 days. Most policies written today feature a 90-day wait.

**Presumptive disability**
Most policies provide that total disability benefits will be paid if the insured loses sight, hearing, speech, both hands, both feet, or one hand and one foot. Some policies do not cover all the losses. Some policies require the loss to be total and permanent while others cover even a temporary loss.

**Example**
Dr. Smith was a physician in a general practice. Due to loss of hearing, he can no longer examine patients. He now works full time as a radiologist, writing reports. He is making more money than he did as a general practitioner. Will he receive his full disability benefits? Yes, he will get full disability benefits under presumptive disability.

**D. Benefit amount**
Long-term plans typically provide benefits ranging from 50 to 60 percent of earnings. The percentage is scaled down as earnings increase. A professional making $400,000 or more may only be able to insure 40 to 50 percent of earnings.

To discourage malingering, and get the injured back to work, a client cannot buy unlimited amounts of disability insurance. In general, disability income plans are designed to provide a level of benefits that replaces 50 percent of an employee's gross income. Some carriers will provide up to 60 percent of an employee's gross income under salary continuation because the disability benefits may be taxable.
Applying the Facts

An insurance agent recommends that his client needs $5,000/mo. in individual disability benefits. The client agrees to buy a policy. The agent will need to obtain all the following information for the insurance underwriter except which of the following items?

A. The client's earned income (W-2 or 1099s) and unearned income
B. The client's net worth
C. The client's current disability coverage (including group disability with employer)
D. The client's complete cash flow statement

Answer:  D  Disability underwriting requires more detailed financial information than life insurance underwriting. The carriers will issue a policy based on earned income offset by unearned income. The applicant may be required to submit a complete financial statement (assets/liabilities but surprisingly not a cash flow statement).

E. Provisions (Riders)

Partial disability benefits
Many carriers add this benefit at no cost. The carrier wants to encourage the insured to resume employment as soon as possible. Benefits usually start after a period of total disability and last up to 6 months. The benefit is usually 50% of the benefit for total disability.

Residual disability benefit (proportional)
This is an expensive benefit but worth the extra premium cost. Benefits usually start after a period of total disability but can start immediately. Benefits are payable for the maximum benefit period under the basic contract. The benefit is payable in proportion to the insured's reduced earnings (20-80% range). This is a rider in an own occupation policy.

Example
Following her accident, Dr. Cureya can only work part-time. Her condition is not expected to improve. Her income is reduced by 60%. Thus, 60% of the total disability monthly amount is payable (proportional).

Guaranteed insurability option
This permits an insured the right to purchase additional amounts of coverage without new proof of insurability. However, the increased coverage is subject to financial underwriting. The option is subject to an additional premium.
Cost-of-living adjustments (COLAs)
This provision addresses increasing benefits during periods of disability. COLAs provide either a fixed-percentage increase or a floating-percentage increase reflecting an inflation index. The option is subject to an additional premium.

Social Insurance Substitute Benefit (SIS)
For total disability, the monthly benefit will be equal to the social insurance substitute (SIS benefit) shown on the policy schedule page less any social insurance benefit (typically Social Security disability payments) received in that month. If the person receives a social security disability benefit, the SIS benefit is terminated or reduced.

There is a 5-month waiting period under Social Security. However, the disabled person generally must wait for 12 months because Social Security will not pay if the disability lasts less than 12 months

Applying the Facts
1. Connie Consultant buys a disability policy with a base benefit of $5,000 and an SIS benefit of $1,200. Connie becomes disabled and ultimately receives $600 in Social Security disability benefits. How much benefit will she receive from her policy when Social Security pays $600?
   A. $600  C. $5,600/mo.
   B. $5,000/mo.  D. $6,200/mo.

   Answer:  C  The $1,200 policy SIS benefit will be reduced by $600. Remember she always gets her base plan benefit ($5,000).

2. What happens if Social Security turns her down for disability benefits?
   Answer:  D  She gets the full $1,200 plus the base ($6,200).

3. What happens if Social Security pays $1,400 in disability income benefits?
   Answer:  B  Connie will only receive her base ($5,000) from the insurer. Social Security benefits will not reduce her base plan. Social Security will pay the $1,400, not the insurance policy. The question is asking about the policy.

F. Taxation of premiums and benefits
The individual owns the contract and pays the premium.
   – Premiums are not deductible.
   – Benefits are tax-free to the employee.

The employee owns the contract and the employer pays the entire premium under a bonus arrangement (Section 162 disability insurance).
   – Premiums are deductible by the employer as a bonus to an employee.
   – Benefits are tax-free to the employee because the premium cost is included in the employer’s Form W-2.
The employee owns the contract and the **employer pays** the entire premium under a salary continuation plan (Group Plan).
- Premiums are deductible by the employer.
- Benefits are taxable to the employee.

**NOTE:** With shared premiums (employee and employer), benefits will be partially tax-free. This is a contributory plan.

**Partnership and S corporation shareholders taxation rules are complicated.**
A partnership or **S corporation** can deduct the premiums paid for coverage for a partner or a greater-than-2% shareholder of an S corporation (deductible business expense). The deduction is based on the premium cost being included in the taxable income of the partner or shareholder (conduit income). Proceeds are then **excludable** from taxable income (**employee pays the premium**).

**NOTE:** Do not confuse premiums and benefits in the questions below.

**Applying the Facts** – individual policy taxation
1. Rudy owns an S corporation. The corporation pays her individual disability insurance premium under a salary continuation agreement. Which of the following is true?
   A. The benefits are tax-free to Rudy.
   B. The benefits are taxable to Rudy.
   C. The corporation cannot deduct the premium.
   D. The premiums paid by the corporation are not a tax consequence to Rudy.

   **Answer:** A  The corporation can deduct the premium. The S corporation charged her with the premiums paid.

2. Uncertain cashflow, Inc has a formal salary continuation plan providing individual disability policies. Due to cash flow problems, the company changes the plan to an informal plan. (Premium is a bonus to the employee.) How will the insurance premiums paid, and the insurance benefits be treated?
   A. Tax-deductible premiums paid by the company, tax-free benefits to the employees
   B. Nondeductible premiums paid by the company, tax-free benefits to the employees
   C. Nondeductible premiums paid by the company, taxable benefits to the employees
   D. Tax-deductible premiums paid by the company, taxable benefits to the employees

   **Answer:** A  With a formal plan, the employer pays the entire cost, and the benefits are included in an employee’s gross income. With an informal plan, the employer uses an employee bonus to pay the insurance premium on selected employees. The employee also pays income tax on that bonus, but would then receive benefits tax-free.
3. Terry is both a shareholder of Able, Inc. and its VP of sales. The company wants to offer an executive incentive plan for Terry. They want to informally fund the plan for Terry, and a few select other key employees using disability insurance. Since only selected employees are eligible, Able will pay the insurance premium through a bonus to those employees. Which of the following is true?

A. If Terry becomes disabled, the disability benefits are taxable.
B. The company cannot deduct the premium because the plan is discriminatory.
C. The company can deduct the premium.
D. An informally funded incentive plan is typically funded with life insurance rather than disability insurance.

Answer: C The company is paying Terry's disability insurance premium and charging him with the income (the bonus) which is subject to tax. If Terry becomes disabled, the benefits will be tax-free. Answer D is true but doesn't answer the question.

4. Nick works for XYZ corporation as a sales manager. The company provides a salary continuation disability insurance program, and it pays the full premium. Nick's benefit under the plan is $10,000 per month. Calculate Nick's net-of-tax monthly benefit if his tax bracket is 32% during disability.

A. $3,200   C. $6,800
B. $5,000   D. $10,000

Answer: C Benefits are taxed at 32%. He nets 68%.

5. What is the answer if Nick (Question #4) paid the premium in full?

Answer: D The benefits would be tax-free.

6. What would the answer to question #4 have been if XYZ offered a Section 162 arrangement?

Answer: D Premiums paid under Section 162 are an allowable business expense. Under this arrangement the business pays a bonus to the employee to pay the premium. 162 is nothing more than a bonus.
7. Sherry has a choice between two disability insurance policies. She is healthy, a professional, and single. She will pay the premium and needs the coverage for a long time.

<table>
<thead>
<tr>
<th>Policy A</th>
<th>Policy B</th>
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<tbody>
<tr>
<td>$3,000 per month of benefits</td>
<td>$4,000 per month of benefits</td>
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<tr>
<td>90-day wait</td>
<td>30-day wait</td>
</tr>
<tr>
<td>Benefits to age 65</td>
<td>Benefits to age 65</td>
</tr>
<tr>
<td>Noncancelable</td>
<td>Noncancelable</td>
</tr>
<tr>
<td>Own occupation</td>
<td>Any occupation</td>
</tr>
<tr>
<td>Premium: $3,900 per year</td>
<td>Premium: $3,000 per year</td>
</tr>
</tbody>
</table>

Which policy would you recommend based on these descriptions?
A. Policy A because of its own occupation definition of total disability
B. Policy B because she is healthy, and the premium will be substantially less over time
C. Policy A because a good job should allow her to begin self-insuring for disability
D. Policy B because it has a 30-day wait and the premium will be substantially less over time

Answer: A "Own occupation" greatly increases the likelihood that the benefit will be paid and is the best answer on the exam.

**Topic 20 Long-term care insurance (individual)**

Private medical insurance policies (both group and individual) generally exclude coverage for long-term care. Medicare is also inadequate due to many restrictions.

A. **Eligibility for benefits**

A chronically ill person has been certified as meeting one of the following requirements:
- The person is expected to be unable to perform, without substantial assistance from another person, at least two activities of daily living (ADLs) for a period of at least 90 days.

Six activities of daily living include (ADLs): eating, bathing, dressing, transferring from a bed to chair, using the toilet, and maintaining continence. Also, long-term care insurance benefits are generally paid when substantial services are required to protect the individual from threats to health and safety due to substantial cognitive impairment (Alzheimer's disease, strokes, or other brain damage).

B. **Services covered**

Types of care - skilled, intermediate, custodial, home health care, and adult day care

NOTE: The home health care benefit can be as much as 100% of the nursing home benefit.
C. Medicare limitations (later in lesson)  
D and E. Benefit period/Elimination period  
LTC policies contain both an elimination period (30 days to 365 days) and a maximum benefit period (2 years to lifetime).

F. See below

G. Provisions  
Inflation protection - If elected (higher premium), the daily benefit can increase by simple interest (5%) or by a compound interest.

Applying the Facts  
Which provision of a long-term care (LTC) policy is generally most important?  
A. Coverage for Alzheimer's disease  
B. Guaranteed renewability  
C. Custodial care benefit  
D. Inflation protection

Answer: D Inflation protection seems the most important. If an insured bought a policy at age 60 with a $200 per day benefit, what would that benefit be worth in 15-20 years if it were fixed at $200 per day? There can be no exclusion for Alzheimer's disease (HIPAA). The policy must be guaranteed renewable (HIPAA). Most policies cover custodial care based on the inability to perform ADLs.

F. Benefit amounts  
There are no limits on the dollar amount per day of coverage that can be purchased (unlike disability insurance). Lower limits of $200 per day can be purchased. Higher limits of $400 or $500 can also be purchased. Policies can provide home health care benefits for an extra premium.

Underwriting  
Underwriting is based on the health of the insured. Numerous questions are asked about the health of the applicant and relatives. Underwriting tends to become more restrictive as the applicant becomes older.

H. Taxation of premiums and benefits - 2020  
For taxable years beginning after 1996, premiums paid and unreimbursed expenses for qualified long-term care services are deductible as itemized medical expenses. However, the deduction is subject to an additional dollar amount limitation that increases with age of the insured individual. Examples: ages 51-60 is $1,630/yr. and 61-70 is $4,350/yr. (2020). Deductions are subject to the 10%-of-AGI floor. Benefits received are generally not taxable subject to dollar caps.

Qualified long-term care policies  
A policy that provides cash at surrender cannot be qualified. It is a nonqualified policy. If this is true, the premiums cannot be deducted.
NOTE: A health FSA (Flexible Spending Account) may not be used to reimburse premiums for LTC and expenses for long-term care services.

Applying the Facts
1. Which of the following statements is not true about long-term care insurance?
   A. Premiums paid are deductible in full.
   B. Unreimbursed expenses are subject to 10%-of-AGI floor.
   C. Premiums paid are included as deductible medical expenses subject to 10%-of-AGI floor.

   Answer: B Premiums are seldom fully deductible. The amount of deductible premium depends on the client's age (Answers A and C).

2. Qualified long-term care policies have all the following characteristics except:
   I. Must be noncancelable
   II. Limited premium deduction based on age (generally, only if itemizing)
   III. Must provide skilled and Alzheimer’s care. There is no daily limit for skilled care only.
   IV. May have cash value

   A. All the above C. II E. I, III, IV
   B. I, IV D. II, IV

   Answer: E LTC policies must be guaranteed renewable. There is no requirement that they be noncancelable. II is correct. However, the income tax deduction (which is subject to a 10% of AGI floor) is further limited to dollar amounts that increase with age. Benefits received tax-free are subject to a dollar cap regardless of the type of care. Qualified LTC policies cannot be cash value policies. However, a “qualified” LTC policy can be a rider in a life insurance policy. LTC insurance that is part of a life insurance policy (or is a rider to a life policy) is a separate contract and therefore does not violate the rules that “the contract cannot provide for a cash surrender value.”

C. Medicare limitations to Long-Term Care Benefit
To qualify for skilled nursing benefits under Hospital Insurance, the patient must meet all these five conditions:
– The patient's condition requires skilled nursing.
– The patient has been in a hospital at least three days in a row before admission to a participating skilled nursing facility.
– The patient is admitted to the skilled nursing facility within a short time (generally within 30 days) after leaving the hospital.
- The patient's care in the skilled nursing facility is for a condition that was treated in the hospital.
- A medical professional certifies that the patient needs and receives skilled nursing care.

**Skilled nursing facility coverage (LTC) - 2020**

Benefits for the first 20 days are paid in full by Medicare. For days 21-100, a co-payment is required of the patient by Medicare. (Insured pays $176 per day.) After 100 days of coverage, the patient must pay the full cost of a skilled nursing facility. Concept rather than calculation is tested.

**NOTE:** To qualify for skilled nursing facility reimbursement, the patient's condition must be expected to improve within a predictable time. Thus, Alzheimer's coverage is excluded.

**Example (skilled nursing facility stay cost $296/day)**

Grandma is in the facility for 110 days. Medicare will pay the full $296 for the first 20 days and then only $120 for the next 80 days. The insured pays $176. There is no coverage after 100 days under Medicare.

---

**Applying the Facts**

1. Which of the following statements are generally true about Medicare coverage regarding long-term care?

   I. It will pay up to the first eighty (80) days of skilled care.
   II. During first 20 days in the facility, a co-payment is required from the patient.
   III. A hospital stay of three days consecutively is necessary to qualify for coverage.
   IV. The care needed must be skilled care.
   V. No more than 30 days can lapse between the hospital stay and admittance to a skilled nursing facility.

   A. I, III, IV  
   B. I, III, V  
   C. II, III  
   D. III, IV, V  
   E. III, V

   **Answer:** D Coverage lasts for up to 100 days; Cost for first 20 days is paid in full under Medicare Part A.

2. Under what Medicare section is skilled nursing covered?

   A. Part A  
   B. Section A  
   C. Part B  
   D. Part D

   **Answer:** A Skilled nursing benefits (extended care) are available under Medicare Part A.
Medicaid
The Social Security Act grants a state (like New Jersey) Medicaid funds for certain individuals whose income and resources are insufficient to meet the cost of necessary medical care. The Medicaid program is jointly financed by federal and state governments and administered by the states. To qualify for Medicaid, applicants must have both income and assets below certain limits, which vary from state to state. A single individual will not qualify for Medicaid in most states unless he/she has less than $2,000 in countable assets.

Applying the Facts
Other than LTC insurance, what other means provide nursing home care coverage for longer than 100 days?
A. Medicare     C. Medicare supplement policy
B. Medicaid    D. Medigap insurance

Answer: B Medicare is limited to 100 days. A Medicare supplement policy or a Medigap policy may provide for a rehabilitation stay but not for nursing home coverage.

Medicaid Lookback Rules
Individuals are generally ineligible for Medicaid coverage if they give money or assets away within five years of incurring nursing home expenses. In addition, people are ineligible if they have more than $595,000 (2020) in home equity. Certain states with higher property values will be allowed to raise this amount to $893,000 (2020). Further, Medicaid recipients who have annuities must name the state as a remainder beneficiary to cover expenses. Another provision lifts a moratorium on the number of states that can choose to offer Long-Term Partnership Programs. Such programs allow people who buy LTC insurance and who later need nursing home care under Medicaid to protect their assets up to the amount of their LTC policies. Services offered by Medicaid are the following.

– Inpatient hospital services
– Physician services
– Outpatient hospital services
– Lab and x-ray services
– Nursing facility services
– Home health services

Applying the Facts
1. Mr. Stillworking, age 54, and Mrs. Stillworking, age 52, are considering purchasing LTC insurance. Their earned income and assets are average for their age bracket. They are concerned that a lengthy period of long-term care could wipe out their assets. Which of the following policies would you suggest?
A. 30-day elimination period, 3-year benefit period
B. 60-day elimination period, 4-year benefit period
C. 90-day elimination period, 6-year benefit period
D. 180-day elimination period, 6-year benefit period
E. 365-day elimination period, lifetime benefit period

Answer: D While the average nursing home stay is around three years, a longer maximum benefit period is advisable. The longer elimination period will lower their premium.
2. Mr. Baker owns Baker Industries, Inc. which operates as an S corporation. The Corporation pays the premium for Mr. Baker’s personally owned disability policy. Which of the following statements are true?
I. Baker Industries can deduct the premium
II. Benefits payable to Mr. Baker under the policy will be tax-free

A. I C. Both I and II
B. II D. Neither I nor II

Answer: C The premium payment passes through to Mr. Baker as taxable income (conduit). He pays taxes on it; therefore, the benefits are tax-free.

3. Lou Jensen, age 58, married Kim, age 39, late in life. Now he is concerned that he may not be able to retire until 70. Kim has two younger children, 16 and 12, who want to attend college and then law school or medical school. Kim insists that he pay for the education. Lou is an attorney with a successful practice. He is worried about his disability insurance. Which feature in his individual disability income insurance policy would probably cause him the greatest concern?
A. Definition – own occupation
B. Guaranteed renewable
C. Elimination period – 120 days
D. Benefit amount – 50% of salary
E. Benefit period – to age 65

Answer: E Mr. Jensen may need coverage to age 70. Answers A, C and D are the best coverage available. Guaranteed renewable (carrier can change the premium) is a concern but the benefit period is a more serious exposure.
Life insurance (individual)

Lesson 6

Life insurance (individual)
A. Concepts and personal use

Personal needs – Life insurance addresses the following needs when the breadwinner dies:
– final expenses  – education needs  – outstanding debt
– survivor's income  – mortgage debt  – special desires*

Personal needs – Insuring the non-working spouse covers the following:
– care of children  – mortgage debt
– care of parents  – special desires (also known as an adjustment fund)

Personal needs – Insuring the joint death of both spouses covers the following:
– estate tax  – family goals
– effective transfer to heirs  – special desires (adjustment fund)

Determining an appropriate amount of life insurance
Needs analysis estimates survivor's needs that must be met following an individual's premature death and compares those needs to the resources available.

Human life value
Human life value analysis is based on the insured individual's income-earning ability; it is the present value of the income lost by dependents as a result of the insured's death. It does not consider other resources available to provide for income and cash needs because of an individual’s premature death.

Example
Presume that Maxwell’s life insurance need (PV) was $350,000. Human life value analysis requires the purchase of $350,000 of life insurance. In contrast, if Max had $100,000 of investments, the needs analysis would only require the purchase of $250,000 of life insurance.

Applying the Facts
1. Which of the following statements is correct concerning the human life value method of determining the appropriate amount of life insurance coverage?
A. It compares needs due to premature death with the resources available.
B. It is the future value of the income earning ability.
C. It factors a discount rate to determine the present value.
D. It is never used if the surviving spouse continues to work (earned income).

Answer: C The human life value is the present value of the presumed income lost by dependents as a result of the insured's death. It does not account for the other resources available to provide for survivors need because of an individual’s death).
2. Which of the following statements is correct?
   A. Single persons never need to buy life insurance.
   B. Married (single wage earner) families always need to buy life insurance.
   C. Married (two wage earners) families never need to buy life insurance.
   D. Both single and married persons usually have some need for life insurance.

   Answer: D  Answers A and C are wrong because or the word "never"; B is wrong because of the word "always."

**B. Policy types**

**Life insurance selection process**

Short-term need/low cost/no cash value

Term Insurance

a. Annual renewable term (ART/YRT)
   - Premiums increase annually.

b. Level Term
   - Premiums level for term of years.

c. Re-entry
   - Re-qualify for low-cost premium through abbreviated underwriting

d. Decreasing term
   - Mortgage protection

e. First-to-die/Joint life
   - Buy-sell or mortgage protection

Long-term need

Higher cost

Cash value

Low risk tolerance

Company controls investment return

Assets part of general account

Whole Life

a. Straight life
   - Lifetime payments

b. Limited-pay whole life
   - Payments for a shorter period of time

Universal Life

- Premiums and the level of protection can be adjusted up or down.

Single Life application

a. death of the primary income provider
b. need to pay off debt/education expenses

High risk tolerance

Client controls investment return.

Assets part of separate account

Variable Life – Premium is fixed.

Variable Universal Life

- Premiums and the level of protection can be adjusted up or down.

Survivorship life / Second-to-die

a. estate liquidity
b. lower cost
Term insurance
Term insurance pays the face amount of the policy if the insured dies during the term of the policy. It provides protection for a definite but limited period of time.

Annual renewable term (ART) or yearly renewal term (YRT)
This type of policy provides protection for one year only but permits the insured to renew the policy for successive periods of one year at a higher premium each year without having to furnish evidence of insurability (pass the insurance company’s physical exam) at the time of each renewal. Disadvantage: The death benefit remains level, but the premium increases each year; the increase becomes substantial in later years.

Level term
This type of policy has the initial premium guaranteed (level) for a period (5, 10, 15, or 20 years). The longer the guarantee, the higher the level premium will be. Disadvantage: At the end of a 20-year level term (for example), the premium at renewal generally escalates (see re-entry provision).

Re-entry provision
This allows the insured to re-qualify at a new level premium (age-based) through a simplified underwriting process to continue the policy at a relatively low rate. If the insured does not qualify due to declining health, he/she may keep the policy but at a much higher premium.

Decreasing term
This type of policy has a level premium, but the amount of death benefit decreases. As the mortgage principal declines, the amount of death benefit declines in a straight line. Usage: The need must indicate a long-term home mortgage.

First-to-die (joint-life)
This type of policy is written on the lives of two or more persons and payable upon the death of the first person to die. First-to-die or joint-life policies can be in the form of term insurance or in some form of insurance that has cash value. The policy has a variety of uses. This policy can be used for mortgage protection, buy-sell arrangements, or as debt protection (for example, large credit card debt).

Applying the Facts
1. Tom, age 32 is married and has two young children. He wants the lowest premium/level death benefit for his insurance needs over the next 20 years. Which type of life insurance would best suit his needs?
   A. First-to-die
   B. 10-year level term with re-entry provision
   C. Yearly renewable term
   D. Decreasing term

Answer: B After each 10-year period, Tom may re-qualify for another ten years of level protection. However, new medical underwriting is required but is simplified. Yearly renewable term becomes expensive over a 20-year period. Answer D is wrong because Tom wants a level death benefit. 20-year level term would a suitable recommendation, but it is not a choice.
2. Bill (age 31) and Rita (age 35), who are joint owners of BR Properties want a simple buyout policy should one of them die. Which type of policy will best fit their needs?
   A. 20-year level term
   B. Annual renewable term
   C. Second-to-die
   D. First-to-die

   Answer: D A first-to-die policy pays the benefit at the death of either Bill or Rita to the survivor.
   Answer A is wrong because the question says, “which type of policy will best fit their needs.”

   **Term insurance provisions**
   **Renewability** - This provision guarantees the policy owner the right to renew the policy for a limited number of years. However, because of the element of adverse selection, the carrier usually imposes an age limit beyond which the renewal is not permitted.

   **Convertibility** - This provision permits the policy owner to exchange a term contract for a contract of permanent insurance within a specific time frame, without evidence of insurability.

   **Applying the Facts**
   Which one of the following statements best describes the conversion provision in a life insurance policy?
   A. The insured may exchange a term insurance policy (ART) for a 30-year level term policy without proof of insurability.
   B. The insured may exchange term insurance for permanent insurance without having to show evidence of insurability.
   C. The insured may exchange permanent insurance for term insurance without proof of insurability.
   D. The insured is guaranteed the right to exchange term insurance for permanent insurance only if he or she becomes disabled.

   Answer: B Under the conversion provision found in most term life insurance policies issued today, a policyholder can only exchange term for permanent.

   **Recommending Term Insurance**
   Term insurance is appropriate when
   – there is a limited time needed for protection (possibly up to 20 years, such as coverage for education needs), and/or
   – when the dollars available for coverage are limited (It is more important to have sufficient coverage than cash values.)

   **Whole life insurance**
   Whole life insurance provides protection for the life of the insured. This does not describe how the premiums are paid, only to the duration of the protection.

   **Straight whole life (ordinary life or continuous premium whole life) insurance**
   With this type of policy, premiums are based on the assumption they will be paid until the insured's death.
Limited-pay whole life insurance
With this type of policy, premiums are limited by contract to a specified number of years. This can be expressed in years (20-pay life) or age (life paid-up at age 65). The limited-pay whole life premium will be higher than the straight whole life premium because the total cost is generally paid over a relatively shortened time period.

Usage of the limited-pay whole life insurance
It is normally used for a long-life expectancy insured. The insured will pay considerably less premium because the premiums are discounted (paid early). However, if death occurs in the early years, the insured would have paid excessive premiums for the benefits.

Advantages of whole life insurance
– It provides permanent protection.
– It has a level premium.
– It combines savings (cash value) with protection.

Disadvantages of whole life insurance
– Premiums must be paid for lifetime (or limited-pay).
– Premiums are higher than term at the beginning.
– It is generally not flexible to meet changing needs (limited to nonforfeiture options).

Life Insurance Policy Type Recommendations
1. John operates his computer repair business as a sole proprietor. Through business dealings and poor personal planning, he owes considerable debt. Lately, however his business is producing significant income. John, age 35, also informs you that he may get married to Wendy, age 33, who has three children. What type of insurance do you recommend currently?
   A. Joint life   B. Decreasing term   C. Straight whole life   D. 10-year level term

   Answer: D  With 10-year level term, over time he can lower the death benefits, cancel the policy, or convert it to a permanent policy. This provides flexibility with his changing needs and cash flow.

2. Mrs. Pitchard, age 65, is a widow with substantial wealth. She has decided to establish a life insurance trust to provide for estate liquidity. Her health is excellent. In view of her parents’ longevity, she expects to live to her mid-nineties or longer. She is concerned with paying premiums for the rest of her life and wants a guaranteed level premium policy. What type of insurance would you recommend at this time for Mrs. Pitchard?
   A. Limited-pay whole life   B. Straight whole life   C. 30-year level term   D. 10-year level term with re-entry provision

   Answer: A  The keys are good health, family members with longevity, guaranteed premiums, and substantial wealth to pay premiums faster, but for a limited time period.
Universal life insurance
The noteworthy feature of universal life insurance is that, within limitations, the premiums, cash values, and level of protection can be adjusted up or down during the life of the permanent contract to meet the owner's changing needs. The interest credited to the policy's cash value is paid at current interest rates (with some minimum guaranteed).

| Premiums paid (credited) | Cash value fund (current interest credited) | less deduction (debit) for -company expenses -mortality (cost of pure protection) |

If the premiums paid plus the current cash value are not adequate to cover the cost of maintaining the policy, additional premiums must be paid to keep the policy in force.

Example
Alex paid his normal premium. $1,000
Policy’s existing cash value is + .500
Company charge for expenses and mortality costs - 1,800
- 300

To keep the policy in force, Alex must deposit additional premiums. (Normal premium of $1,000 plus existing $500 CV less expense of $1,800 equals $300 additional premium to keep the policy in force.) The adjusted premium to keep the policy in force would be the normal premium plus $300.

Withdrawals and loans
Withdrawals - The policyholder can make partial withdrawals from the policy's cash value. There is no requirement to repay the loan. The death benefit will be reduced by the outstanding loan balance. If the policy is not a modified endowment contract (MEC) the withdrawal amount is not taxed.

Loans - The company normally credits a lower interest rate on that portion of the cash value associated with the policy loan.

Death benefit alternatives
Level death benefits - The death benefit is constant, generally ignoring the cash value increases (also called Option A) (same as whole life). When the cash value exceeds certain benchmarks, the death benefit will increase (shown on the next page at point X). This is required by the 1984 tax act.

Increasing death benefit (also called Option B) - As the cash value increases, the death benefit increases proportionally.

NOTE: Unless the question indicates that it is an Option B or increasing death benefit arrangement – it is presumed that it is an Option A policy. Then only the face value is paid to the beneficiary and considered for estate tax purposes.
Example of death benefit options

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**Universal Life/Variable Universal Life**

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<table>
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</thead>
<tbody>
<tr>
<td>Cash Value</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

Example

Years ago, Ulysses bought a $100,000 universal life policy. If the accumulated cash savings account balance was $20,000, what amount would be the death benefit?

“A” level (type I death benefit) – $100,000 death benefit

“B” increasing (type II death benefit) – $120,000 death benefit ($100,000 plus the cash value of $20,000) (The increased death benefit increases the premium.)

Applying the Facts

Sixteen years ago, Ron Stillman purchased a $100,000 universal life policy. He elected the increasing death benefit option. Over the years the policy accumulated $25,000 of cash value. After Ron died an old friend told Mrs. Stillman (the beneficiary) that she will lose the cash value of his policy. How much will the company pay her?

A. $25,000  
B. $75,000  
C. $100,000  
D. $125,000  

Answer: D  
Because the policyowner elected Option B, the beneficiary will be paid the death benefit plus the cash value. Answer C reflects Option A. The cash values would be retained by the company at death. Only the face value would be paid to the beneficiary.

Variable universal life

This type of policy provides many features of universal life insurance and offers policyowner-directed investment options of a variable annuity. Like variable annuities, the policies are classified as securities and subject to regulation by the SEC. They are also subject to regulation by state insurance departments. Agents must be FINRA licensed (at least a Series 6) and life insurance licensed to sell variable life insurance.

Separate accounts

As with universal life contracts, the policy's cash value and ultimate death benefit is not guaranteed. However, unlike whole life and universal life, the insured's cash value is invested in a separate account (not in the insurer's general account). The general account (called the legal reserve) is a liability of the insurance carrier. If a carrier fails, the general account will probably be frozen (no surrenders, loans, or withdrawals) whereas the separate account will not be frozen.
Applying the Facts
Mr. Jones, age 65, purchased a whole life policy with Mutual Benefit Life in 1980. In 1991 the company failed, and his policy cash value rights were restricted for almost 10 years. He has come to you for advice on additional insurance needs. He has told you of his concerns about carrier failure. Which type of policy should you advise him to buy?
A. Limited-pay whole life  C. Single premium universal life
B. Universal life    D. Variable universal life

Answer:  D  His concern is that if he purchases another policy like whole life or universal life and the company fails, his cash values will be tied up (general account). Therefore, you should suggest a variable policy (separate account). Mr. Jones doesn’t have to invest the cash value in equities.

Other types of life insurance
Endowments
An endowment at age 100 is like a whole life policy. Most endowments were 20- or 30-year maturities or maturity dates of ages 55, 65, or 70. Since the 1984 tax act, most traditional endowment contracts will not qualify as insurance contracts.

Regarding the test, endowment contracts are wrong or not usable answers.

Second-to-die / Survivorship Life (last to die)
This is a contract that insures two lives with the promise to pay only at the second death. The policy's main usage is to provide liquidity to pay federal estate taxes at the death of the second spouse. With significant increases in federal estate tax exemptions, it is likely that new purchases of second-to-die policies will decline.

The premium is significantly lower than the cost of separate policies on the two individuals. This policy can be in the form of a whole life, universal life, variable universal life, or term coverage.

Applying the Facts to Policy Selections
1. Timmy, age 30, is considering four different life insurance policies for his family's needs. Timmy's dad and mother have died at fairly young ages due to health problems. If he lives until retirement age, he would like the policy to provide income for some of his retirement needs. Timmy works in a high paying job, but the company is very shaky. Which policy is his best option?
A. Variable universal  C. 20-year level term
B. Whole life    D. Annual renewable term

Answer:  A  Variable universal should meet his family needs and retirement needs with flexible premiums. If Timmy pays a higher premium for the first few years, then if his employer fails, he can reduce or stop paying the premiums.
2. Tammy, age 32, is a single mother with two children ages 6 and 8. She makes $46,000 per year as an administrative assistant. Her employer provides her with two times salary (maximum $50,000) group life insurance. She owes a minimum amount of debt but owns very few assets. Which of the following types of insurance is most suitable for Tammy?

A. 15-year level term
B. Universal life
C. Whole life
D. Variable universal life

Answer: A Tammy needs substantial amounts of protection. With income yearly of $46,000 while raising two children, it is unlikely that she can afford premiums for a cash value type of policy.

3. Kate is divorced. Due to a favorable settlement, she is set financially. In addition, her ex-husband is still paying alimony. Kate enjoys investing in the stock market. She follows market conditions closely. As part of the divorce settlement, her ex-husband has agreed to allow her to own a policy on his life. What would you suggest she do?

A. Nothing, she is financially secure.
B. Nothing, she no longer has an insurable interest.
C. She should buy a variable universal life policy and pay extra premium into the policy.
D. She should buy a universal life policy and pay the minimum premium.

Answer: C Kate can choose and change the sub-accounts. She seems to have a high-risk tolerance.

4. Spencer Spender, age 30, has a wife and two young children. Spencer makes a lot of money, but both he and his wife spend most of it. Spencer doesn't feel this will ever change. He feels he needs a life insurance program that will force him to put away money. Which program would you suggest?

A. 30-year level term
B. Variable universal life
C. Whole life
D. Second-to-die whole life
E. Universal life

Answer: C A whole life insurance policy will force Spencer to pay premiums (a forced savings plan), and will provide coverage for his whole life. The second-to-die policy is normally purchased for estate liquidity. With the variable universal and universal life policies, he will not be forced to pay the premium.
5. Constantine Conservative is considering purchasing either a whole life or a variable universal life policy. What would be the most important reason for buying the whole life policy?

A. He must pay premiums until age 100.
B. He has a low risk tolerance.
C. He will get permanent protection until age 100.
D. He will have a cash value he can borrow from should he need money.

Answer: B  In determining whether a variable life policy is suitable, risk tolerance is the most important factor. Paying premiums until 100 does not sound like the most important reason. Some policies now go beyond age 100. Answers C and D are true for both whole life and variable.

6. Mr. X (age 50), owner and president of X Inc., wants his equity to be bought out by Mrs. T in 15 years. Which type of policy will best fit Mrs. T's needs?

A. Variable life  C. 10-year level term
B. Whole life  D. Annual renewable term

Answer: A  The cash value component along with the growth potential of the variable life policy is often the best solution for funding a buy-sell agreement. Mrs. T could use the cash value to fund the buy-sell if Mr. X doesn’t die within the 15-year time horizon. Typically, a buy-sell arrangement ultimately becomes a 10-year installment sale. Then the time frame becomes more like 25 years (15 + 10).


(No additional premium)

Automatic premium loan - (for whole life policies)
If APL is elected and if the policyholder doesn't pay the premium during the grace period, the company will automatically pay the premium and charge it against the cash value of the policy (and the death benefit).

Grace period -
An additional time, normally 31 days, to pay the premium

Reinstatement clause -
Gives the owner of a lapsed policy the right to reacquire the coverage under certain conditions (proof of insurability and payment of premiums in arrears plus interest)

Misstatement of age clause -
The benefits under the policy will be adjusted to that which the premium paid would have purchased at the correct age.

NOTE: The grace period, the automatic premium loan provision and even the misstatement of age clause are all designed to keep the policy in force.
**Incontestable clause** - The insurer will not contest the policy after it has been in force for a specific period, usually two years. Important exceptions are the following:
-- No insurable interest at the inception of the policy
-- Intent to murder
-- A healthier person (the beneficiary, for example) impersonated the applicant in the medical examination

**Suicide clause** - If the insured commits suicide during the first two years of the policy, the insurer will be liable only for a return of the premium.

**Applying the Facts**
In 2000, Matthew Mature applied for life insurance. He was born in 1951. When the agent asked him his age, he said 51, and the agent wrote 1949 on the application. If Matthew dies, will the carrier pay the death benefit?
A. Yes, the death benefit will be adjusted upward.
B. Yes, the death benefit will be adjusted downward.
C. No, the policy will be deemed null and void, and the premiums will be returned.

Answer: A Matthew is younger (age 49); therefore, the premium will buy more insurance (misstatement of age). If he was born in 1949 and says he’s age 49, then the premium would buy less insurance because he was actually age 51.

**Riders (extra premium applies)**
1. Disability waiver of premium
   a. Whole life policies
      The company agrees to waive all premiums due after the policyowner has become totally and permanently disabled. The cash value is credited as if the policyowner had paid the premium.
   b. Universal and variable universal life policies - normally two choices
      -- The company just waives the charges for mortality and administration expenses but does not include an increment to the policy's cash value, or
      -- The company waives the full premium that the client would normally pay.

**Example**
Edward Extracash, age 25, paid substantially more premium ($5,000) into his universal life policy than the required premium ($1,000). If he elects waiver of premium and becomes disabled, what happens to the cash value?
-- Under waiver of mortality and administration expenses, those charges are waived by the insurer. The cash value would only grow by the interest credited to the account.
-- Under waiver of premium, the premium would be added to the policy's cash value. The mortality and expense charges would come out of the cash value. Any excess premium increases the policy cash value account.

2. Guaranteed purchase option (guaranteed insurability option)
The insured may purchase additional insurance, regardless of insurability, at three-year intervals and up to a specified maximum age.
Applying the Facts
How would you, a CFP® Professional, best explain the guaranteed insurability option to your client?

A. You will never have to take an insurance exam again to purchase more insurance.
B. If you exercise the option, the premium is guaranteed for the life of the contract.
C. You can purchase the right to acquire additional insurance in specified amounts at specified times or ages. (No exam required)
D. If you exercise the option, you have the right to continue to keep that policy in force by timely payments of the premium.

Answer: C Guaranteed purchase (insurance) enables the policyholder to increase the death benefit. The insured is not required to furnish proof of insurability.

3. Accidental death (double indemnity)
This normally doubles the standard death benefit if the insured dies accidentally. This extra benefit does not affect any needs analysis calculation.

Applying the Facts
Which of the following are life insurance riders that generally require extra premiums?

I. Disability Waiver Provision – Company agrees to waive all premiums due after the insured has become totally and permanently disabled.
II. Conversion Provision – Insured is granted option to exchange term contract for some type of permanent insurance without having to prove evidence of insurability.
III. Accidental Death Benefit – If the death of the insured is caused by an accident, an additional sum equal to the face value of the policy will be paid.
IV. Guaranteed Insurability – Insured may purchase additional amounts of insurance at stated intervals without providing evidence of insurability.

A. All the above C. I, III, IV E. III, IV
B. I, II, III D. II, III, IV

Answer: C The conversion provision is not a rider. It’s a standard contract provision.
D. Dividend options (participating policies)

<table>
<thead>
<tr>
<th>Option</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash option</td>
<td>Dividends paid to policy owner in cash (generally not taxable)</td>
</tr>
<tr>
<td>Reduction of premiums</td>
<td>The insurance company simply subtracts the amount of the dividend from the premium due and sends a premium notice for the remainder.</td>
</tr>
<tr>
<td>Accumulated with interest</td>
<td>Dividends remain with the insurance company in an interest-bearing account. Interest paid on the dividends is taxable (although the dividend itself typically is not taxable). Dividends are added to the death proceeds or, if the policy is surrendered, to the cash value.</td>
</tr>
<tr>
<td>Purchase paid-up additions</td>
<td>Each dividend is used to purchase (on an attained-age basis) a small amount of additional, fully paid-up whole life insurance. The additions are added to policy face value to determine the death benefit. The cash value of the paid-up additions whole life insurance is added to the guaranteed cash value of the basic policy to calculate the surrender value.</td>
</tr>
<tr>
<td>One-year term insurance</td>
<td>All or a portion of the dividend is used to buy one-year term insurance equal to the policy's base cash value (not the cash value of the paid-up additions). On the test, this is the fifth dividend option.</td>
</tr>
</tbody>
</table>

Applying the Facts

Barry Buyer plans to buy a participating whole life insurance policy. He is trying to decide on the best dividend options. Which of the following is true?

A. If he allocates the dividends to reduce his premium, the dividends will be taxable.
B. If he allows the dividends to accumulate with interest, the interest is taxable.
C. If he purchases paid-up additions with his annual dividends, the death benefit of the base policy will decrease.
D. If he buys one-year term with the dividends, the policy will expire when the dividends are too low to pay the premium.

Answer: B Unless the policy is a MEC (Modified endowment contract), the dividends are tax-free (return of unused premium). The paid-up additions will add additional death benefit. If the dividends are too low to buy the one-year term coverage, the option may expire but the policy will remain in force.
E. Nonforfeiture options
Policy provision provides a number of protective options for the policy holders who stop paying premiums for any reason. Part of the cash savings account equity is not lost, but can be used in several ways.

Cash option - The policy may be surrendered at any time for its cash value, less any policy indebtedness plus accumulated dividends. Protection terminates.

NOTE: A 6-month delay clause applies to distributions of cash values (rarely imposed by carriers but asked on the test). A company is in financial difficulties cannot cash out everyone. It prevents the carrier from bankruptcy.

Reduced amount of - The face amount of the policy will be reduced. The paid-up insurance death benefit will be the amount the cash value would purchase as a net single premium. No additional premium is due.

Paid up term insurance - The policy may be continued in force for as long as the cash value will permit. No additional premiums are due. If the insured outlives the term, the policy stops. At the end of the term, the cash value is zero.

Nonforfeiture Table (Dollar values per $1,000 of Face Amount)

<table>
<thead>
<tr>
<th>End of Policy Year</th>
<th>Cash or Loan Value</th>
<th>Paid-up Insurance</th>
<th>Extended Term Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$0</td>
<td>$0</td>
<td>0 years</td>
</tr>
<tr>
<td>2</td>
<td>10</td>
<td>50</td>
<td>3 years</td>
</tr>
<tr>
<td>3</td>
<td>20</td>
<td>100</td>
<td>6 years</td>
</tr>
<tr>
<td>4</td>
<td>35</td>
<td>175</td>
<td>10 years</td>
</tr>
</tbody>
</table>

Examples using the above chart
Jay, age 35, bought a $100,000 whole life policy four years ago. He wants to know his options if he decides not to pay more premiums. (NOTE: $100,000 ÷ 1,000 = 100)

Cash option - The company sends him a check for $3,500 ($35 x 100). The policy is terminated.

Reduced paid-up - The company issues him a paid-up policy for $17,500 ($175 x 100). The reduced policy continues for his whole life with no additional premium due.

Extended term - The company keeps the $100,000 policy in force for 10 years using the existing cash values. After 10 years, the policy will terminate. NOTE: This option puts the insurance company at a greater risk. The insurance company can use a higher mortality table.
Why is APL important?
Jay, from our previous example, forgets or is unable to pay the third year annual premium during the grace period. He did not check the APL box in the policy application.
-- Under the reduced paid-up option, he can maintain $5,000 of coverage (50 x 100). To reinstate the policy, he would have to prove insurability.
-- Under the nonforfeiture option of extended term, he would have $100,000 of coverage for 3 years. To reinstate the policy, he would have to prove insurability.
-- Under the APL provision, the policy would remain in force with a policy loan outstanding. He can pay off the loan with interest at any time. He is not required to reinstate the policy.

NOTE: When he does not pay the 3rd year annual premium, the nonforfeiture table uses year 2 amounts.

Applying the Facts
From the nonforfeiture table and example above (Jay), what would be true after 3 years?
A. If he cashed in the policy, he would receive $200 from the insurer.
B. If he elected the extended term option, he would continue $10,000 of paid-up insurance for 6 years.
C. If he elected the extended term option, after 6 years of coverage, he would be paid $2,000 in cash.
D. The extended term option will use the $2,000 in cash to pay the premium for 6 years.

Answer: D The cash value will maintain the original death benefit for six years. Answer A is wrong because $20 x 100 = $2,000 not $200. Answer B should be $100,000 for 6 years. Answer C is wrong because after 6 years, no cash remains. Jay chose a term policy.

F. Settlement options
Distributions upon surrender or payment on insured’s death
Cash option - Owner or beneficiary takes a lump sum.
Interest option - The proceeds are retained temporarily by the insurer, and only interest is paid. NOTE: This option gives the owner or beneficiary time to consider other settlement options or to take a lump sum later.
Installments for a fixed period - The proceeds plus interest are paid out over a specific interval (up to 30 years).
Installments of a fixed amount - The proceeds are paid out in a fixed amount ($1,000 per month, for example) for as long as the proceeds plus interest will last.

NOTE: The installment options may operate as spendthrift options. The spendthrift clause denies the beneficiary the right to assign his/her interest in the policy proceeds. Creditors of the beneficiary cannot get to the death proceeds left with the insurance company.
Life income options - Same options as are available under the annuity settlement options
- pure life or single life - period certain
- joint and survivor - refund

Nonforfeiture Dividend Settlement
Cash Cash Cash
Reduced paid-up insurance Reduces premium due Interest only
Extended term Accumulate with interest Fixed period
Paid-up additions One-year term Fixed installment
One-year term 4 life income options

Applying the Facts

1. Nettie Needavacation purchased a $50,000 whole life policy 10 years ago. She would like to continue the $50,000 policy for a period of time but pay no additional premiums. If she does so, which option would she use?
   A. Pure life    C. Reduced paid-up insurance
   B. One-year term   D. Extended term

   Answer: D Extended term would keep the $50,000 policy in force for a term of years. Pure life is an annuity settlement option. One-year term is a dividend option. Electing reduced paid-up insurance would reduce the death benefit of the policy.

2. Wanda Wannacar borrows substantially from her whole life policy. She is concerned about the reduced death benefit. Which dividend option should she elect?
   A. Paid-up additions    C. Reduced paid-up insurance
   B. Extended term     D. 5th dividend

   Answer: D The 5th dividend option will buy an amount of one-year term insurance equal to the outstanding loan. Paid-up additions may or may not be equal to the amount of the loan.

3. If a client opted to use one of the nonforfeiture options for his $100,000 (face value) whole life policy, which one of the options allows the insurance company to use a higher mortality table than on the original policy if the cash value is $10,000?
   A. Reduced paid-up whole life    D. 5th dividend option
   B. Extended term     E. Premium loan
   C. One-year term

   Answer: B Extended term option puts the company more at risk ($100,000 death benefit) than reduced paid-up. (Death benefit could be $25,000, for example.) Insurance companies are permitted to use higher mortality tables (adverse risk) for the extended term option.
G. Illustrations
The policy illustration provides financial information regarding a new policy. A copy of the preliminary illustration should be given to the client. When the policy is issued, a final illustration must be included with the policy. If multiple carriers are to be considered, the illustrations can serve as a basis for comparison.

National Association of Insurance Commissioners (NAIC)
The NAIC is a voluntary association of the insurance administrators from each state. The NAIC has no legal power over insurance regulation. Nevertheless it enables state commissioners to exchange information and coordinate regulatory activities.

Life Insurance Policy Illustration Model Law
The model law specifies how an insurance company may illustrate life insurance policy values. Where the law applies, illustrations must meet the requirements of the model law.

NAIC life insurance illustrations – model regulation
(applies only to non-variable life insurance policies)
1. All illustrations must be certified annually by an illustration actuary.
2. Copies of the illustrations must be sent to the insurer along with the policy application.
3. Copies of the illustrations must be signed by the applicant and by the agent.
4. In addition to the illustrations provided at the time of sale, the insured must be given an annual report on the insurance company.
5. The policy cannot be represented as anything other than a life insurance policy.
6. The model prohibits the use of the term "vanish" or "vanishing premium."
Illustrations (which must be labeled "life insurance illustration") must include the following:
1. Name of insurer
2. Name and address of producer
3. Name, age, and sex of proposed insured
4. Underwriting and rating classification
5. Initial death benefit

Applying the Facts
Which of the following accurately reflects the functions and purposes of the NAIC?
I. Oversees state accreditation program
II. Promotes law and regulation uniformity
III. Transmits information to regulators
IV. Protects the interest of policy owners while preserving state regulations
V. Enacts legislation for regulation of the insurance industry
A. All of the above C. II, III E. V
B. I, II, III, IV D. IV

Answer: B While the NAIC generates “model legislation,” it has no power to make laws.
Watch list
12 financial ratios help NAIC it keep tabs on insurance companies. If a company has 4 of its 12 ratios outside the "usual ranges," it is put on the NAIC watch list.

H. Viatical and life settlements (and accelerated benefit rider.)
Viatical settlements entail the sale of the policy for less than full face value. Such sales typically occur when the insured is terminally or chronically ill.

Accelerated benefit rider
This rider pays a portion of the policy's death benefit of the contract early if the insured is medically certified to be terminally ill. After 1996, a terminally ill or chronically ill individual may exclude from income amounts received from the accelerated benefit rider.

Qualifying medical conditions are acute coronary artery disease, permanent neurological deficit, end-stage renal failure, AIDS, or such a medical condition that drastically limits the insured normal life span (example: 2 years or less). To qualify as accelerated benefits, the lifetime payments must reduce the death benefit payable under the contract.

Example #1
It is expected that Terry has less than 2 years to live due to coronary artery disease. He has limited funds to take care of himself. What might he receive under an accelerated benefit clause? If he has a $400,000 life policy with a 50% accelerated benefit rider, he could withdraw up to 50% of the policy's death benefit ($400,000 x 50%). If he elects this option, the remaining death benefits ($400,000 - $200,000) will be paid to the beneficiaries named in his policy. No income taxable events occur at the time of withdrawal to Terry or at death to the beneficiary.

Chronically ill (accelerated benefit rider)
The IRC defines an individual as chronically ill if the person meets one of the following standards:
-- unable to perform at least two activities of daily living
-- a certain level of disability
-- requires supervision for protection due to severe cognitive impairment

Terry example continues (accelerated benefits rider)
If Terry was only chronically ill, the tax-free distribution from the life insurance policy may only be used to pay only be for costs incurred by Terry for qualified long-term care services. In addition, the tax-free benefit would be offset by long-term care costs indemnified by insurance or other providers.

Viatication
Viatical payments – entail the sale of a terminally ill person's life insurance policy to a business that specializes in such transactions. The IRC deems a person terminally ill if he or she is certified by a physician as having a condition that can be reasonably expected to result in death within 24 months of the date of certification.
Terry example continues
From the previous page, what happens if Terry’s policy has no accelerated benefit rider? He could sell it to a viatical company.

If Terry receives $300,000 from the viatical company in exchange for his policy, how much would be taxable? The sales proceeds are tax-free. He has less than 2 years to live (definition of terminally ill).

NOTE: The death benefit is not included in his gross estate. However, the sales proceeds not spent $300,000 is included in his estate. The viatical company will pay tax at ordinary income tax rates on the gain. The gain is the death benefit of $400,000 less the $300,000 payment and any premiums paid by the viatical company (its basis).

What if Terry miraculously recovers? The IRS will not retroactively tax (recapture) Terry’s benefit.

Life settlements (Viatical company)
A life settlement is usually a transaction involving an insured who is not terminally or chronically ill and is generally over age 65. Since the settlement does not deal with a terminally ill person, the participants in a life settlement transaction are taxed as follows.
-- Tax-free basis (premium paid)
-- Ordinary income from the basis to the policy’s cash surrender value
-- Long-term capital gains from the higher of either the cash surrender value (or the federal income tax basis) to the net settlement proceeds

Terry example continues
What happens if Terry had more than 2 years to live?
Answer: We would need to know the premiums paid ($20,000), the cash value ($30,000), and the cost of insurance ($3,000). Below is his tax situation on the proceeds from selling his policy to a viatical company.
-- The basis (premiums) are tax-free ($20,000).

The cost of insurance affects the premium paid ($20,000 - $3,000) or basis. Terry will have to recognize income of $283,000 ($300,000 -17,000). This income is characterized as ordinary income to the extent the cash value exceeds the premium paid ($30,000 – 20,000) or $10,000. The balance will be treated as “capital” gain ($283,000 – 10,000) or $273,000.
Applying the Facts

1. Paul suffers from an incurable disease and a maximum life expectancy of 2 years. He would like to live his remaining days seeing the world. He is covered under a life insurance policy with a death benefit of $500,000 and $40,000 of cash value. A viatical settlement company has offered him $325,000 in cash. If he sells the policy and the viatical company pays 8 more premiums of $4,000 each before Paul dies, which of the following is true?
   I. The $325,000 paid to Paul is received tax-free.
   II. $285,000 ($325,000 paid less $40,000 cash value) is taxable to Paul.
   III. The $500,000 death benefit is tax-free to the viatical company.
   IV. $357,000 of the death benefit is tax-free to the viatical company.
   A. I, III  
   B. I, IV  
   C. II, III  
   D. II, IV

   Answer: B Because Paul is terminally ill, he receives the sales proceeds tax-free. When the $500,000 is paid as a death benefit to the viatical company, the company's basis in the policy is $357,000 ($325,000 + $32,000). The difference of $143,000 is taxed as ordinary business income to the viatical company.

2. Freida wants to sell her life insurance policy to a viatical company. Does she have to prove to the company that she is terminally ill to get the proceeds federal income tax-free?
   A. No, the sale of the policy is automatically tax-free.
   B. No, the sale is just a return of her cash and unused premium.
   C. Yes, the viatical company must justify the purchase of the policy to their investors.
   D. Yes, she must be certified by a physician as having a condition that can be reasonably expected to result in death within 24 months of certification.

   Answer: D Viatical companies typically require the insured to sign a release allowing the viatical company access to the applicant's medical records to provide a reasonably accurate estimate of life expectancy.
3. Leroy is terminally ill from COPD. He owns a whole life contract with a death benefit of $1,000,000. The cash value of the contract is $100,000. He paid premiums of $50,000 (dividends were used to reduce premium). If he sells the policy for $600,000 to a viatical settlement company, what will be the tax result to Leroy?

A. $600,000 will be tax-free
B. $400,000 ($1,000,000 less $600,000) will be tax-free
C. $500,000 will be tax-free ($600,000 less $100,000 CV)
D. $550,000 will be tax-free ($600,000 less $50,000 premiums paid).

Answer: A Because Leroy is terminally ill, he will receive the sales proceeds tax-free.

Applying the Facts:
1. Mr. Carr, age 40, is married with 2 teenage children. He has just joined a new firm that provides group medical insurance (PPO), one-times salary group life and a 401(k) plan. He will be eligible to participate in the group plans in one month and the 401(k) in three months. He is concerned about his family’s needs if he dies. Both of his parents died before age 70. His health is good but he continues to smoke heavily. Recently, his wife has taken a part-time job (30 hours per week). She receives no benefits. With limited assets and college costs (no money saved), money for college may be needed in the next few years. What type of life insurance policy do you suggest?
A. 30-year survivorship life policy
B. Limited pay whole life
C. Universal life Type B
D. 10-year level term
E. Variable universal life Type A

Answer: D Mr. Carr needs a lot of coverage at a low cost. This would leave money to also contribute to a 529 plan or to the 401(k). It is likely that he can convert the term policy to a permanent one sometime in the future. Answer A is not available, and Mr. Carr does not need a second-to-die policy. Answer B is very expensive. Answers C and E are more expensive than term.
2. Russell, age 60, is a widower. He is still grieving for his late wife and does not plan to remarry. His children are grown and on their own. As he approaches retirement he is trying to reduce his expenses. He plans to retire in approximately three years at which point he would lose any benefits from his employer. He will elect COBRA to take him to age 65 and Medicare. His other benefits including group life (3 times salary) and group disability will cease. Many years ago he bought a $100,000 whole life policy. He accumulated substantial amount of dividends that are buying additional paid-up insurance. What do you suggest he do if he would like to retain some life insurance but not pay any further premium?
A. Cash in the policy and use the proceeds to buy a single premium variable universal life policy.
B. Use future dividends to pay the premium in full
C. Each year surrender enough existing paid-up insurance (dividends are released) and stop paying the premium.
D. Elect the reduced paid-up nonforfeiture provision

Answer: D Under the reduced paid-up nonforfeiture option, the death benefit will be reduced and premiums will cease. Answer A will trigger income tax effect and new underwriting. Answer B and C would be good answers if he wanted to retain the whole $100,000.

3. Claire, age 59, is divorced. Her children supported her ex-husband in the divorce. She no longer speaks with them. She recently met Joe, age 56, also divorced, who is supporting his children and grandchildren. He continues to work and is in good health. If she marries him, she plans to ask for a pre-nuptial agreement to keep her assets separate. She wants whatever assets that remain at death to go to her favorite charity. She plans on using most of her financial resources over her life expectancy. She is considering life insurance to benefit Joe should she die first. What type of policy do you suggest if she is in good health and a non-smoker?
A. Annually renewable term insurance policy
B. 10-year level term policy
C. A whole life policy
D. Universal life policy paying the minimum premium

Answer: C Annual renewable term will become increasingly expensive. The whole life policy would feature a guaranteed premium and cash value. She may have a 30-year life expectancy. If Joe died before her, she could cash the policy in or leave it to her selected favorite charity. It is doubtful that she will only need coverage for 10 years. The universal policy would operate much like the annual renewable term (each year more expensive).
4. Mr. and Mrs. Substantial have a growing net worth that currently exceeds $30 million, but their business makes up 80% of their assets. Their debt is minimal, but they fail to save each year except for 401(k) elective deferrals. They have a nice country home and at least once a month have an expensive party for friends and relatives. They enjoy spending time with their 3 married children and 6 grandchildren. Both have been told by doctors that their lavish lifestyle is worsening their health. None of their family members works in their business. They are worried about the future of their business and potential estate taxes after they both die. What do you suggest they do?
A. Find a buyer for their business
B. Clean up their act, take care of their health, stop the parties, and save money
C. Buy a first-to-die whole life policy
D. Buy a second-to-die variable universal life policy
E. Buy an insurance policy on the most insurable person

Answer: D Their need for cash to pay federal estate tax and bequests are likely to occur at the second death. A second-to-die policy will base the premium on their joint life expectancy which is usually more favorable than a single life policy. Answer A does not fit the clients’ needs. The question does not say they want to sell their business. No age is given, they could be in their 50’s.

5. Francis Frail’s doctors said that her life expectancy was two years at most. Given that unfortunate prognosis, Francis sold her universal life insurance policy having a face value of $500,000 to Viatical Views for $400,000. One year later a new experimental drug cures Francis. Regarding this situation which statement below is accurate?
A. Francis will now be taxed retroactively on $400,000 minus her premium basis.
B. Francis will have no further tax consequences.
C. Viatical Views must return the policy to Francis who will then return the $400,000.
D. Francis will owe capital gains tax on the $400,000 reduced by the amount of her premium basis.

Answer: B Although Francis is no longer deemed to be terminally ill, there will be no recapture of the proceeds from her viatical settlement.
Income Taxation of Life Insurance

Lesson 7  Income taxation of life insurance

Taxation of whole life insurance
Cash value - Cash value above cost basis at the time of surrender is taxed as ordinary income.

Examples
Sam purchased a whole life policy years ago. Currently its values are as follows:
Policy face amount $100,000 death benefit
Premiums $2,000/year
Dividend $1,200 (next year's)
Cash value $35,000
Paid-up additions $30,000 death benefit
Cash value of paid up additions $20,000

Sam's current options
1. He may receive next year's dividend ($1,200) in cash or use it to reduce his premium due, or
2. He may continue to use the dividend to buy additional paid-up additions (death benefit).

When Sam dies
Policy face amount $100,000
Paid-up additions 30,000
Death benefit paid $130,000

If Sam surrenders policy
Cash value $35,000
Cash value of paid-up additions 20,000
Surrender value $55,000

What are Sam’s options if he elects that his dividends also buy the one-year term option and takes a loan against the policy of $50,000?
Policy face amount $100,000
Paid-up additions + 30,000
Less loan - 50,000
Policy death benefit* $80,000
One-year term** + 35,000
Entire death benefit $115,000

* If Sam did take a $50,000 loan, his death benefit would decrease by $50,000. However, he could use a portion of the dividend to buy one-year term insurance equal to the policy's then cash value (not including dividends) with the remaining dividends used to continue to buy paid-up additions.

** The one-year term option only buys term insurance up to the (pre-loan) amount of cash value of the policy. NOTE: The one-year term does not buy term insurance to cover the paid-up additions’ cash value.
A. Dividends
Dividends - Dividends paid are generally treated as a return of unused premium and are not income taxable. (Non-MEC)

B. Withdrawals and loans
Examples
Toby, age 65, bought a whole life policy years ago. He surrenders the policy. The following facts apply:
- Cash value: $50,000
- Premiums billed: $35,000
- Existing loan: $30,000
- Dividends reducing premium: $15,000

1. What amount would he receive from the insured at the time of surrender?
   $50,000 – 30,000 = $20,000 (cash value less loan)

2. What amount would be taxable?
   $50,000 – 20,000 = $30,000 (cash value less basis) $30,000 is taxable as ordinary income (not capital gains). The dividends are a refund of unused premium.
   *(35,000 billed - 15,000 dividends = $20,000 basis)

Applying the Facts
1. Shelly, age 60, owns a $100,000 limited pay whole life insurance policy with a yearly premium of $5,000. After 10 years, she surrendered the policy. The current values are the following:
   - Net cash value: $15,000
   - Outstanding loan: $30,000
   - Dividends used to reduce premiums: $10,000

What will her tax situation be?
A. $5,000 capital gain
B. $5,000 ordinary income
C. $5,000 capital loss
D. $5,000 ordinary loss
E. $25,000 ordinary loss

Answer: B  Gain that occurs when a life insurance policy is surrendered is generally taxed as ordinary income.

   Net cash value: $15,000
   Outstanding loan: $30,000
   Actual cash value: $45,000

   Less basis:
   - 10 years of premium billed: $50,000
   - Dividends used to pay premiums: $10,000

   Ordinary income: $5,000
When the question provides **net cash value**, factor the outstanding loan. The net is the cash value less the loan.

Janet, age 65, bought a whole life policy years ago. She has decided to surrender the policy. These are the facts:

- Guaranteed cash value: $75,000
- Dividends used to reduce premium: $10,000
- Existing loan: $30,000
- Premiums billed: $60,000

2. What amount of cash would Janet receive at the time of surrender?
   - A. $30,000
   - B. $45,000
   - C. $55,000
   - D. $85,000

   Answer: B  
   The cash value less loan ($75,000 - 30,000)

3. What amount of the distribution would be taxable?
   - A. $15,000
   - B. $20,000
   - C. $25,000
   - D. $50,000

   Answer: C  
   The taxable amount is the guaranteed cash value less the net premiums that were actually paid ($60,000 - $10,000) is taxable ($75,000 - 50,000 = $25,000).

**C. Death benefits**

The death benefits are generally **income** tax free to the beneficiary (an exception may apply under the transfer-for-value rule).

**The Uniform Simultaneous Death Act (USDA)**

The USDA provides that any persons who dies within 120 hours of each other, by law, predecease each other. This rule keeps the property of one deceased person from passing through the estate of another deceased person before passing to those who survive both.

**How the USDA Works**

Mr. and Mrs. Boyd are in a car accident. Mr. Boyd dies immediately at the site of the accident, then Mrs. Boyd dies on the way to the hospital.

Mr. Boyd’s assets bypass Mrs. Boyd’s estate due to USDA rules. The assets pass to others.

The USDA assumes that Mrs. Boyd was already dead. This keeps his assets out of her estate.

In regards to Mrs. Boyd, the Act also assumes Mr. Boyd dies before her and keeps her assets out of his estate.
D. Modified endowment contracts (MECs)

The internal revenue code defines a life insurance contract for income tax purposes. The policy must meet either of the following tests to qualify: the cash value accumulation test or the guideline premium and corridor test. Otherwise, the policy is classified as a modified endowment contract (MEC) and thus taxed like an annuity.

A contract is defined as a "modified endowment contract" if it meets the requirements for classification as a life insurance contract (the 1984 Act) and was

1. entered into on or after June 21, 1988, and
2. fails to meet the "seven pay test."

The 1988 Act eliminated most sales of single premium life insurance contracts. (the 1984 Act).

Taxation of distributions under a modified endowment contract is similar to the taxation of a deferred annuity. In a modified endowment contract, loans against the contract are also treated as distributions.

-- Distributions are taxed under the "interest-first" rule.
-- If a taxable distribution, which is not part of an annuitized distribution, is received under the contract before age 59-1/2 and the policyowner is not disabled, it is subject to a 10% federal penalty tax.
-- Dividends paid by mutual life insurance companies under modified endowment contracts are taxable as income if they are used as follows.
   a. if they are received in cash or to reduce premiums due
   b. if they are retained by the insurer in repayment of a policy loan
-- The death benefit is excludable from income.

7-pay test

Policies that fail the 7-pay test because excess premium has been paid within the first seven years are classified as MECs. A single premium policy issued after 1988 is always a MEC for the CFP Board Certification Examination.

Example

Martin purchased a single-premium policy in 1996. Obviously, the policy fails the 7-pay test. Later, Martin exchanges his single premium policy for a larger level premium policy that clearly passes the 7-pay test. The new policy will be treated as a MEC (although it is a level premium policy).

Example

If the annual net level premium for a $100,000 7-pay policy is $4,500, then the maximum non-MEC premium allowed in the first year is $4,500. After the first year, both annual and aggregate rules apply. If the client only pays $3,000 in the second year, he/she could pay $6,000 in the third year (the normal $4,500 plus a make–up of $1,500 from the second year). The MEC possibility goes on for 7 years (total $31,500 of premium). If the insured exceeds these limitations in any of the first 7 years, the policy is a MEC. Remember - once a MEC, always a MEC. Paying lower premiums in later years does not remove MEC status. The problem with MECs is that withdrawals and loans are LIFO plus 59-1/2 penalty. The death benefits are still tax-free.
Applying the Facts

1. Simon Singlepremium purchased a $100,000 whole life policy in 1985. He deposited $50,000 in a single premium. Today, the policy has a cash value of $90,000 and a death benefit of $130,000. Which of the following statements are true?

A. If he withdraws $40,000, he will have to pay ordinary income tax on the withdrawal.
B. If he borrows $40,000, he will have to pay ordinary income tax on the loan.
C. The excess $30,000 of death benefits will be treated as capital gain if he dies.
D. If he cashes in the policy, he will have to declare the $40,000 as ordinary income.
E. There is no deferral on the increase in cash value because the policy is violating the cash value accumulation test.

Answer: D The policy was purchased before 1988. The MEC rules do not apply (Answers A and B).

2. If Simon (Question #1) had purchased the policy in 1990, what would be true? After 1988, a single premium policy will be a MEC. Therefore, a distribution or a loan of $40,000 would be taxed as ordinary income plus 10% penalty if he was under age 59-1/2.

NOTE: The difference between MEC and non-MEC contracts is that loans and withdrawals are generally not taxable.

Material change
A policy that at first passes the 7-pay test when issued can later become a MEC if there is a "material change" in the policy. A material change is any increase in the death benefit under the contract.

Grandfathered life insurance rules (Contracts issued both prior to June 1988 and the death benefit increases after 1988)
– If the death benefit increases by more than $150,000, the contract becomes subject to material change rules and may lose its grandfathered status. (Rule #1)

Rule #1 example
John purchased a $500,000 universal life policy in 1987. He paid a level premium since then. He needs an additional $200,000 in death benefit. If he exercises his guaranteed insurability (no proof of insurability) option for $200,000, could the policy become a MEC? Yes, it may become a MEC. The coverage is increasing by more than $150,000. If John only exercised his option up to $150,000, could the policy become a MEC? No, the test is "more than" $150,000.

– If the policy death benefit is increased or an additional qualified benefit is purchased and the contract owner did not have the right to obtain such an increase or addition without providing additional evidence of insurability, it may lose its grandfathered status. (Rule #2)
Rule #2 example
Jane purchased a $100,000 universal life policy in 1986. She has paid a level premium since the purchase date. Now she needs an additional $50,000 with proof of insurability. If she increases the original policy by $50,000, could the policy become a MEC?
Yes, it may become a MEC. Because she will have to show proof of insurability.

Applying the Facts
1. Patricia buys a whole life insurance policy. She pays the normal level premium. Which of the following statements is not true?
A. She can borrow money from the contract without incurring income tax on the loan amount.
B. If she borrows money from the contract, the loan interest is personal interest and is not deductible.
C. If she dies, the death proceeds are paid income tax-free to the beneficiary.
D. If she surrenders the contract, the cash value paid to her will be tax-free.

Answer: D  Answer D is not always true. If, on surrender, the policy has a gain above basis, the gain would be taxed as ordinary income. Interest on policy loans are no longer deductible. The question does not indicate that the policy is a MEC.

2. Sidney Seniorcitizen purchased a $250,000 universal life policy in 1985. He is the named insured. He paid a lump sum. He has decided to increase the death benefit by $100,000. Will the policy become a MEC?
A. It always has been a MEC.
B. It may if he has to prove insurability.
C. No, it retains its grandfather status.
D. Yes, it will become a MEC.

Answer: B  If the policy death benefit increases by any amount and Sidney had to provide additional evidence of insurability, it may lose its grandfather status. Answer D does not address proof of insurability.

3. In 1979, Mr. Williamson purchased $200,000 universal life policy with a $150,000 guaranteed insurability option (GIO). He will exercise the $150,000 option to increase the death benefit. Will the policy become a MEC?
A. It always has been a MEC.
B. It may if he increases the death benefit by more than $150,000.
C. No, it retains its grandfather status.
D. Yes, it will become a MEC.
Answer: C  He is only increasing the death benefit up to the grandfathering limit of $150,000, and he does not have to prove insurability. While Answer B is true, it doesn’t answer the question.

NOTE: Material change may also affect policies issued after 1988.

E. Transfer for value
The most important exception to the general rule of exclusion of life insurance death proceeds from federal income taxation to the beneficiary is the transfer for value rule. This rule provides that if a policy is transferred from one owner to another for valuable consideration (typically, but not always money), the income tax exclusion is lost (example: viatical settlement). Policy transfers that are not jeopardized by the transfer for value rule are as follows:

- transfer to the insured
- transfer to a partner of the insured (partnerships)
- transfer to a corporation in which the insured is a shareholder or an officer
- transfer pursuant to a divorce agreement

Transfers for value could occur, for example, when a corporation changes its buy-sell agreement from a stock purchase (entity) arrangement to a cross purchase plan and transfers company insurance policies to stockholders other than the insured. A corporate key person life insurance policy is transferred to the insured's spouse, adult child, or an irrevocable trust to keep the proceeds out of the insured’s estate could trigger a transfer for value exposure. The policy is usually purchased for its current cash value.

3-person business case (TRB, Inc.)
Todd owns a corporation worth $1.5 million equally with Ryan and Bill. **Todd owns two policies ($250,000 each) on Ryan and Bill** to buy their interests upon death. Todd dies first. Ryan ($250,000) and Bill ($250,000) buy Todd's interest for $500,000 and now own a 50/50 interest in the business. However, Ryan only owns a policy on Bill for 33% ($250,000 policy/business interest $750,000) and the same for Bill/Ryan situation. Should Ryan buy the policy that **Todd owned on Bill** from Todd's estate? No, this will create a transfer for value. Only Bill should buy the policy on Bill’s life policy from Todd's estate.

**TRB, Inc. - $1.5M business valuation**

Todd dies – stock redeemed  Then Bill (50% owner), only owns $250,000 policy on Ryan

Todd’s estate owns two polices  $250,000 on Ryan and $250,000 on Bill

Should Bill buy Ryan’s policy from Todd’s estate?  NO, due to the transfer for value rules. Ryan has the same problem if buying Bill’s policy from Todd’s estate.

**Example**
ABC, Inc. owned $1,000,000 policies on Bill and Sam (stock redemption). The replacement cash value of Sam's $1,000,000 policy was $50,000. Bill **purchased** Sam's policy from ABC, Inc.
to change to a cross-purchase agreement. He then paid five $15,000 annual premiums before Sam died. Bill's basis is $125,000 \([\$50,000 + (5 \times \$15,000) = \$125,000]\). Bill must report $875,000 of the death benefit as ordinary income \((\$1,000,000 - \$125,000)\). Why? Because the transaction is taxable due to transfer for value because Bill bought Sam's policy (violation).

If ABC were a partnership, would the answer change?

Answer: Yes, a transfer to a partner (Bill) is an exception to the transfer for value rule.

Applying the Facts

1. Jenny and Penny own JP, Inc. They plan to sell the business and retire. JP, Inc. owns two policies – one on Jenny and one on Penny. Jenny and Penny want your recommendation on what to do with the policies after they retire. What do you suggest?
   A. JP. Inc. should keep the policies.
   B. Jenny and Penny should buy their own respective policies from JP, Inc.
   C. Jenny should buy Penny’s policy from JP, Inc., and Penny should buy Jenny’s policy from JP, Inc.
   D. Jenny’s policy should be transferred to a family member or her irrevocable trust, and Penny should do the same thing with her policy.

Answer: B Each owner should buy the policy under which she is insured. Answer A is ineffective after the company is sold. Both answers C and D violate transfer for value rules. The business is a corporation not a partnership.

2. Under an insured cross-purchase buy-sell agreement, what is the major problem at the death of one shareholder, Tom, if there are five other owner-shareholders?
   A. It is cumbersome to get all the money together to buy the equity of the deceased owner.
   B. The purchase of shares from the estate of the deceased owner will cause income tax problems to the estate.
   C. The life insurance will be subject to the creditors of the corporation.
   D. The sale of the policies of a particular shareholder owns to the other owners affects taxation of the death benefits.

Answer: D When the policies are sold by Tom’s estate to the other owners (not the insureds) transfer for value problems occur. Tom's estate gets a step-up in basis on his equity, so there should be no income tax problem (answer B). The insurance isn't owned by the corporation, so its creditors can't attach the insurance (answer C).
**Spouses/children**
A gift of a policy to a family member causes a taxable gift but not a transfer for value because no consideration is received.

A sale of a policy to a family member (other than the insured) is not a taxable gift but does cause a transfer for value.

**F. Section 1035 exchanges**
The Internal Revenue Code provides the following tax-free exchanges of life insurance and annuity contracts.

-- the exchange of a life insurance policy for another life insurance policy or for an annuity contract
-- the exchange of an annuity contract for another annuity contract
-- Tax-free exchanges are now permitted from life insurance and annuity contracts to qualified long-term care policies.

NOTE: If an exchange involves life insurance policies, the policies must have the same owner and insured, or if an annuity is exchanged, the contracts must name the same owner and the same annuitant(s). Otherwise, the exchange does not qualify as a tax-free exchange.

**Applying the Facts**
1. Ted's parents bought him a $50,000 life insurance policy when he was age 2. Now at age 25, he is the owner of the policy. It has $10,000 of cash value. Ted is planning to get married shortly. He wants to know which of the following options are available:
   I. He can cash it in for $10,000 (may be partially taxable).
   II. He can exchange the policy for a larger face value (tax-free exchange) with proof of insurability.
   III. He can roll the cash value into an annuity (tax-free exchange).
   IV. He can exchange the cash value for a single life immediate annuity (tax-free payout).
   V. He can select the extended term nonforfeiture option.
   A. All the above  C. I, II, III  E. IV, V
   B. I, II, III, V  D. II, III

   **Answer:** B Answers II and III are permissible 1035 exchanges. Answers I and V are nonforfeiture options. Answer IV is incorrect. The taxation of the payout is based on the inclusion/exclusion rules.

2. Fran Fine exchanges a $250,000 ordinary life insurance policy for an annuity contract. Fran paid $40,000 of premium over the life of the contract. The cash value of the contract is $38,000. What is the basis of the annuity contract?
   A. $38,000
   B. $38,000 Fran will realize a $2,000 ordinary loss.
   C. $40,000
   D. $250,000

   **Answer:** A The basis of the annuity contract is the amount of premium paid, adjusted for any gains or losses.
3. Question #2 continues. What would Fran's basis be if she had used $10,000 in dividends to reduce the premiums?

A. $10,000  
B. $28,000  
C. $30,000  
D. $40,000  
E. $0

Answer: C The basis of $40,000 less $10,000 dividends used to reduce the premiums over time.

4. From the list below, what are the reasons why an insurance company would issue a Form 1099 to a policyowner?

I. The dividends were being held to accumulate with interest.
II. The dividends were used to purchase paid-up additions
III. The owner cashed in the policy which had a basis greater than its cash value
IV. The policy was a MEC and the owner had made a withdrawal
V. The whole life policy was a MEC and dividends were used to reduce premiums.

A. I, III, IV  
B. I, IV, V  
C. I  
D. II, III, IV  
E. II, V

Answer: B In answer I, the interest is taxable (but not the dividends themselves). In answer II, the dividends are not taxable. In answer III, part of the surrender value would have been taxable if the cash value exceeded the basis. Answer IV and V are both MEC situations that trigger tax consequences.

Applying the Facts:

1. Toby Smith bought a universal life policy in 1998. He paid the minimal premium since 1998. He needs $200,000 more life insurance coverage for a limited period of time. His health is good. He now has enough money to pay higher premiums. What would you suggest he do?

A. If Toby adds $200,000 of coverage to his existing policy it will become a MEC.
B. If Toby adds $200,000 of coverage to his existing policy, the premium of his existing policy will adjust to his current age.
C. Toby should buy a level term policy with a face value $200,000 based on the time element.
D. Toby should exchange his existing policy into a new policy with $200,000 more coverage.
2. Silvia Taylor, a widow is approaching retirement. Her husband died a few years ago. Besides inheriting his whole estate, she received the proceeds of his life policy of $500,000. Uncertain of what to do, she left the $500,000 with the insurance company under the interest only settlement option. Now she would like to place the $500,000 with a money manager. What will be the tax situation on the distribution of the $500,000?
A. The $500,000 will be paid to Silvia tax-free
B. The $500,000 will be subject to a 10% penalty.
C. The gain over basis will be subject to ordinary income.
D. She will not be able to request a lump sum payment because she elected a different settlement option.

Answer: A The $500,000 is an income tax-free death benefit. The policy’s basis is immaterial. The interest settlement option gives her complete flexibility.

NOTE: Interest paid on the $500,000 will be taxable.

3. Many years ago John Little’s parents bought a whole life policy on his life. When he got married, they assigned the ownership to him.

<table>
<thead>
<tr>
<th>Face</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium paid</td>
<td>$10,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>Buying paid-up insurance</td>
</tr>
</tbody>
</table>

He continued to pay the premium ($750 per year) for 20 years. Now he needs some cash to pay for his daughter’s education but he wants to keep the full death benefit of the original policy in force.

<table>
<thead>
<tr>
<th>Current Face</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividends</td>
<td>Buying paid-up insurance ($25,000 DB and $15,000 CV)</td>
</tr>
<tr>
<td>Cash Value</td>
<td>$35,000 (not including dividends)</td>
</tr>
</tbody>
</table>

What would be the most cost-effective method of getting $10,000 in cash?
A. Take a loan of $10,000 from the policy’s cash value
B. Withdraw $10,000 from the policy’s cash value
C. Surrender paid-up insurance equal to $10,000 of cash value
D. Surrender the contract and buy a new more cost effective policy
Answer:  C  If John surrenders the paid-up additions only, proceeds will be mainly tax-free and the only the dividend sourced death benefit (DB) will be reduced. If he does A, the loan will reduce the net death proceeds and the interest on the loan is not deductible. Withdrawals are not available with a whole life policy. He must take a loan.
Business Uses of Insurance / Annuities

Lesson 8  Business uses of insurance
A. Buy-sell agreements

Buy-sell agreements are arrangements for the sale of the individual's interest in a business due to death or disability. The agreement may be structured under a stock redemption (entity purchase) or a cross-purchase agreement. Both arrangements are typically funded by life insurance.

Example - two equal owners (Howie and Frank)
Basis $1,000 each  Current FMV of HF, Inc. is $1,000,000.  
Purchase $500,000 life insurance policies on the two owners' lives (Howie and Frank)

<table>
<thead>
<tr>
<th>Buy-sell</th>
<th>Stock Redemption (Entity Purchase)</th>
<th>Cross-Purchase (Stockholder Purchase)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General</td>
<td>The corporation agrees to purchase the stockholder’s interest for $500,000 using life insurance.</td>
<td>One stockholder agrees to purchase a deceased stockholder’s interest for $500,000 using life insurance.</td>
</tr>
<tr>
<td>Practicality</td>
<td>Practical with multiple owners</td>
<td>Cumbersome with multiple owners</td>
</tr>
<tr>
<td>Life insurance Owner/beneficiary</td>
<td>The corporation is the owner and beneficiary of the policies on lives of each shareholder.</td>
<td>Life insurance generally is required by each shareholder on the lives of the other shareholders.</td>
</tr>
<tr>
<td>Life premiums</td>
<td>Nondeductible</td>
<td>Nondeductible</td>
</tr>
<tr>
<td>Howie dies.</td>
<td>$500,000 income tax free to corporation, company buy stock/ Frank’s basis is $1,000/ Frank now owns 100%.</td>
<td>$500,000 income tax-free to Frank, he buys stock Frank gets step-up in basis on shares purchased of $500,000. Frank owns 100%.</td>
</tr>
<tr>
<td>Rights of creditors</td>
<td>Life insurance can be attached.</td>
<td>Life insurance cannot be attached.</td>
</tr>
<tr>
<td>Frank sells company for $1,000,000.</td>
<td>Gain is $999,000 ($1,000,000 less basis of $1,000).</td>
<td>Gain is $499,000 ($1,000,000 less basis of $1,000 plus shares purchased of $500,000).</td>
</tr>
</tbody>
</table>

Benefits of the Buy-Sell agreement
– It guarantees a market for the business interest.
– It provides liquidity for the payment of death taxes and other estate settlement costs of the deceased owner.
– It helps establish the estate tax value of the decedent's business interest.
– It enables the business to continue in the hands of the remaining owners.
– It makes a business a better credit risk.

Step-up in basis
1. Stock purchase: Company owns the policy. The company receives the benefits. Frank’s basis remains unchanged. Howie’s estate gets a step-up in basis.
2. Cross purchase: Frank owns the policy. His interest gets a step-up in basis. Howie’s estate enjoys a stepped-up basis.
Applying the Facts
Bill and Jack own BJ Industries, a corporation. They are considering adopting a cross-purchase buy-sell arrangement. Bill’s wife is Lynn, and Jack's wife is Jane. Who should own and be the beneficiary of Bill's policy?
A. Jack should own the policy and should be the beneficiary.
B. Bill should own his policy and should be the beneficiary.
C. Jack should be the owner, and Jane should be the beneficiary.
D. Bill should be the owner, and Lynn should be the beneficiary.
Answer: A In a cross-purchase buy-sell agreement, the surviving owner buys out the deceased owner. Jack needs to be both the owner and the beneficiary to keep the policy out of Bill's estate and out of the corporation's assets. The proceeds of the buy-sell arrangement are paid to Bill's estate by Jack.

Disability buy-sell versus life buy-sell agreements of XYZ, Inc. (Howie and Frank)
Buy-sell agreements can be triggered by Howie’s disability or death.

<table>
<thead>
<tr>
<th>Premium paid by XYZ, Inc.</th>
<th>Disability (Entity purchase)</th>
<th>Life (Entity purchase)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Not deductible</td>
<td>Not deductible</td>
</tr>
<tr>
<td>Benefits to XYZ, Inc.</td>
<td>Tax free</td>
<td>Tax free*</td>
</tr>
<tr>
<td>Benefits to Frank</td>
<td>Own more equity (no step-up)</td>
<td>Same - no step-up</td>
</tr>
<tr>
<td>Benefits to Howie</td>
<td>Capital gains above basis</td>
<td>Howie’s family benefits</td>
</tr>
<tr>
<td>Benefits to Howie’s family</td>
<td>None</td>
<td>Step-up in basis (tax free)</td>
</tr>
<tr>
<td>Benefit payments</td>
<td>Lump sum or installment</td>
<td>Same - lump sum/installment</td>
</tr>
</tbody>
</table>

Entity purchase example
Howie and Frank have entered into a life and a disability corporate buy-sell agreement (entity purchase). Each owner's basis in the stock is $1,000. The FMV of Howie’s stock is $500,000.
-- If Howie dies, the corporation will redeem the stock for $500,000. The stock in his estate will enjoy a full step-up in basis. No income tax will be due. The $500,000 in proceeds will be included in his estate. Frank will own more of the company, but his basis will not change.
-- If Howie becomes disabled, the corporation will redeem his stock for $500,000. He will realize capital gains on $499,000 ($500,000 - $1,000). Complete redemption of closely held stock is treated as a capital gain. Frank will own more of the company, but his basis will not change.

Applying the Facts
1. If Frank had purchased a $500,000 policy on Howie’s life with a single premium (MEC policy) and Howie died, how would the death benefits be treated?
   A. It would be subject to income tax
   B. It would be subject to income tax plus a 10% penalty
   C. It would be income tax-free
   D. It would be taxable to the extent that the death benefit exceeds the policy’s cost basis (aggregate premiums).

Answer: C Death benefits from MEC contracts are tax-free.
2. Mr. A is a 50% owner with Mr. B in AB Corporation. They have a cross-purchase buy-sell agreement. How should Mr. A's life policy be structured if the corporation is worth $1,000,000?

<table>
<thead>
<tr>
<th>Owner</th>
<th>Beneficiary</th>
<th>Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Mr. B</td>
<td>Mr. B</td>
<td>$500,000</td>
</tr>
<tr>
<td>B. Mr. B</td>
<td>Mr. B</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>C. Mr. B</td>
<td>Mrs. A</td>
<td>$500,000</td>
</tr>
<tr>
<td>D. AB Corp.</td>
<td>AB Corp.</td>
<td>$500,000</td>
</tr>
<tr>
<td>E. AB Corp.</td>
<td>Mr. B</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

Answer: A Mr. B should own the policy (50% of $500,000) and be its beneficiary in a cross-purchase.

3. If AB Incorporated has an entity purchase agreement, how should the policy be structured?

Answer: D

4. Question #2 continues. Mr. B's basis in the business is $50,000. If he becomes disabled, the corporation will redeem his stock for $500,000. What amount of capital gains will Mr. B realize?

A. $50,000    C. $450,000
B. $250,000    D. $500,000

Answer: C He will realize the redemption price of $500,000 less his basis of $50,000

Examples of buy-sell agreements and transfer for value exposures

Loretta Taylor and Sara Little own LTSL, Inc. Their basis is $100,000 each. They are equal owners (total value $1,000,000 set by buy-sell agreement).

A. If they sign a stock redemption buy-sell agreement and Loretta dies, what happens?
   1. LTSL, Inc. would buy Loretta’s shares from her estate for the previously agreed upon value ($500,000).
   2. Loretta’s basis steps-up (no income tax due), but the buy-sell proceeds are included in her estate ($500,000).
   3. Sara would then own 100% of LTSL, Inc. ($1,000,000), but her basis remains unchanged ($100,000).
   4. Sara could either leave her buy-sell policy in LTSL, Inc. or buy it from the company. (She is the insured, so this will not cause a transfer for value problem.)

B. If they enter a cross-purchase buy-sell and Loretta dies, what are the tax consequences?
   1. Sara would buy Loretta’s shares from her estate for the previously agreed upon value ($500,000).
   2. Loretta’s basis steps up (no income tax due), but the buy-sell proceeds would be included in her estate ($500,000).
   3. Sara would own 100% of LTSL, Inc. Her new basis equals the buy-sell value of $500,000 plus $100,000. She uses the insurance to buy Loretta's shares.
   4. Sara could buy the policy Loretta owned on Sara’s life from Loretta’s estate. (She is the insured, so this will not cause a transfer for value problem.)
B. Key employee life insurance
Key person life insurance is acquired to protect an employer against economic loss from the death of a valued employee. The business should be the owner and beneficiary of the key employee's life insurance. The premiums for key employee insurance are nondeductible while the death benefits are received tax-free.

Applying the Facts
Bob is a key employee of BB, Inc. Bob is retiring, and the company says they will sell the key person policy on Bob. Who can purchase the policy without triggering a transfer-for-value problem?
A. Bob  C. Bob's children
B. Bob's wife  D. Bob's life insurance trust

Answer: A Only Bob, the insured, can purchase the policy without triggering the transfer for value rule.

C. Split-dollar plan
Split dollar life insurance is an arrangement under which an employer and an executive share costs and benefits of a life insurance policy. There are two methods of split-dollar.

1. The endoRsement method – The employer owns the policy and has the responsibility for premium payment. The employer's share of the benefits is secured through its ownership of the policy. A beneficiary is named to receive the employee's share of the death proceeds.

2. The collateral aSSignment method – The insured employee is the policy owner. The corporation lends the employee the corporation's share of the annual premium, and the loans amounts are secured by the assignment of the policy to the corporation. The corporation receives its benefits as assignee of the policy at the earlier of the employee's death or the termination of the split-dollar plan.

![Diagram of split-dollar plan]

EndoRsement method
- Employee is the owner.
- Employee is not a shareholder.
- Death or policy surrender
  - Employer retains cash value of the policy (or premiums paid if greater).
  - Employee’s beneficiary gets balance of death benefit.

Collateral aSSignment method
- Employee is owner.
- Employee is a shareholder.
- Employee aSSigns the policy.
- Death or policy surrender
  - Employer receives premiums paid.
  - Employee gets balance of cash value (surrender), or beneficiary gets balance of death benefits.

Employee is charged with Table 2001 insurance cost.
Applying the Facts

1. Under the endorsement form of split-dollar life insurance, which of the following is true concerning the insured's wife presuming that the insured employee specifies that she is to be his named beneficiary?
   I. She is the owner of the policy.
   II. She is the primary beneficiary of the policy.
   III. She is the premium payor.
   IV. She is a virtual secondary beneficiary.
   V. She is the absolute assignee.

A. I, II, V  C. II, V  E. IV, V
B. I, III, IV  D. III, IV

Answer: E  Under the endorsement form, the owner and premium payor is the corporation (employer). The corporation is the primary beneficiary to the extent of premiums paid or cash value. Thus the insured's wife is functionally a secondary beneficiary. The benefits of the policy can be absolutely assigned. Absolute assignment means the insured gives up the right to change the beneficiary. Therefore, he has no incidents of ownership (the right to change the beneficiary), and the benefits from the policy are removed from his estate. The 3-year rule is still applicable from the time the absolute assignment is signed.

2. Sandra is the CEO of a small, profitable corporation. She wants more personal life insurance, and she would like the corporation to pay the premium. Which policy would benefit her the most?
   A. Endorsement type split-dollar
   B. Collateral assignment type split-dollar

Answer: B  Sandra will own the policy. At death or termination, the premiums paid by the corporation are assigned (paid) back. However, any excess cash value above premiums will be Sandra's. Ownership of excessive cash values is the advantage to the covered employee with collateral assignment. Collateral assignment is a disadvantage to a corporation because the corporation does not own the excess cash values. That is why the endorsement method is typical for the employee who is not a shareholder.

D. Business overhead expense insurance (BOE)
These policies cover the ongoing costs of operating a business while the business owner is totally disabled. Actual expenses (but not the owner's salary) are reimbursed during the time of disability up to a maximum monthly benefit usually for up to 1 to 2 years.

1) Sole Proprietors (self-employed)
The IRS has ruled that premiums paid on an overhead expense disability policy – that reimburses professionals or owner-operators for overhead expenses actually incurred during periods of disability – are deductible as a business expense and that the proceeds are taxable.

2) Corporations (Regular and S corporations)
The corporation cannot deduct the premiums it pays but can exclude the insurance benefits from its gross income. Since the disability income is tax-free, deduction for the premiums is disallowable.

Applying the Facts
1. Sue, a CFP® registrant, has been asked to provide advice for a fee on a Professional Association (A PA is a corporation.) buy-out arrangement. Which of Sue's statements is inaccurate?
   A. The PA should select cross-purchase arrangement to give the surviving officers a step-up in basis.
   B. The PA should purchase a Business Overhead policy to fund the disability buy-out arrangement.
   C. If the PA implements a redemption type (entity) buy-out, the life insurance proceeds would be tax free.
   D. Cross-purchase life insurance policies may be subject to the transfer for value rule at the death of one of the officers (multiple owners).
   E. Whether a cross-purchase or redemption method is chosen, the premiums for the insurance are not deductible.

   Answer:  B  Answer B is inaccurate. A business owner’s policy is not effective to fund a buy-sell agreement. This type of policy covers the costs of operating a business while the owner is totally disabled, and not the owner’s salary.

2. Lucy's Landscape Architects regularly incurs $8,000 per month in overhead expense. Her S corporation should do which one of the following to cover those expenses?
   A. Increase Lucy's individual disability insurance benefits to cover the overhead expenses
   B. Acquire a business overhead policy to cover Lucy's salary ($8,000/mo.) and overhead expense ($8,000) and deduct the premium
   C. Acquire a business overhead policy to cover the overhead expense ($8,000) and deduct the premium
   D. Acquire a business overhead policy to cover the overhead expense ($8,000) but not deduct the premium

   Answer:  D  BOE premiums paid by a corporation are not
deductible. Business overhead insurance cannot cover or pay for the owner's salary. It is only for the business expenses of the entity.

Annuities
For the exam, the presumption is generally that annuities are annuitized. An annuity is a periodic payment from an account maintained by a life insurance company beginning at a specific or contingent date and continuing for a fixed period or for the duration of a designated life or lives.

A. Types
Annuities may be classified in many different ways.

1. Types: Immediate, Fixed, and Variable (also indexed).
2. Periods: Accumulation and annuitization
3. Payout methods: life, period certain, joint with survivor

B. Uses
Pure life annuity
A pure life (or straight life) annuity provides periodic benefit payments as long as the annuitant lives, with the payments ceasing upon the death of the annuitant.

Advantages of a pure life immediate fixed annuity
– Annuitant has a guaranteed stream of income no matter how long the annuitant lives.
– No residual value remains in the policy at the annuitant's death that would be subject to estate taxes.
– This annuity has the highest payout among all the settlement options.

Disadvantages of a pure life immediate fixed annuity
– Annuitant receives a fixed payment (no inflation hedge).
– Annuitant cannot "commute" the remaining value. In other words, the annuitant cannot change his mind and ask for the principal back after his health changes.
– Annuitant may die before the return of the entire principal is realized. Nothing is left for the annuitant's beneficiaries.

NOTE: A fixed annuity payout can lose most of its purchasing power in 30 or 40 years.

Example #1
Louis Longevity is age 65 and in excellent health. His parents lived into their 90s. If Louis buys a pure life immediate fixed annuity that will pay him $2,000 per month, what are the advantages and disadvantages of this annuity payout option?

– Louis will receive $2,000 per month for as long as he lives (advantage), but at age 90 a $2,000 per month payout will not have the same purchasing power (disadvantage).
– When Louis dies, the policy is removed from his estate (advantage), but nothing will pass to his heirs (disadvantage).

Example #2
Polly Paymybills, a widow age 78, owns about $14.0 million in total assets. She owns a spacious home, personal property, and an auto, totaling $2,000,000. She owns about $12.0 million in CDs, government bonds, and a GNMA bond fund. She asks how she can receive more guaranteed income and reduce future estate taxes.

Answer: If she purchases a $500,000 pure life immediate fixed annuity, her payout could be $60,000+/year guaranteed for life (approximately a 13% payout; not a 13% return). Further, the $500,000 is removed from her estate. This provides income and could reduce or eliminate future estate taxes. The payout is partially tax-free (return of basis) under the annuity inclusion/exclusion rules.

Example #3
Joe, an engineer, will retire at age 65. He is a participant in a pension plan with only annuity payout options (no lump sum). Joe asks the employee benefits department for his pension payment options:

- Joe, age 65 - $5,000 per month pure life
- Joe, age 65, and his wife, age 50 - $3,375 per month joint and survivor

Answer: This is a "pension max" strategy entails electing a single life annuity (pure life) on Joe only and using part of the higher monthly benefit ($5,000) to purchase life insurance on Joe. The life insurance death benefit can provide annuity benefits to Joe's wife if he predeceases her.

Factors Influencing the “Pension Max” Decision:
- Joe's health: The annuity pension payout selection should be based on Joe's life expectancy.
- The cost of the life insurance will be based on Joe's life expectancy.
- Joe's wife: Her age and life expectancy will determine her retirement needs should Joe die before her.

Example #4
Pete Pizzalover is a widower, age 75, with about $500,000 invested in fixed income accounts. Although he appears in good health, you find out he is on high blood pressure medication, a bit overweight, and a borderline diabetic. You also find out he exercises regularly, and his parents both lived into their 80s in spite of similar medical problems. What should you recommend?

Answer: Some annuity companies offer simplified annuity underwriting. The carrier may issue a pure life immediate annuity based on a shortened life expectancy, possibly providing a higher payout.

Period certain annuity
Potential buyers may object to placing a substantial sum into a contract that promises no return if death occurs shortly after the annuity payments begin (pure life). This potentially significant loss of wealth (often to a family) is reduced in an annuity with a certain number of payments guaranteed, regardless of whether the annuitant lives or dies. Guarantee periods are 5, 10, 15, and 20 years. However, the longer the guarantee period, the lower the annuity payout (see example below).

Example $100,000 lump sum deposit:
Refund annuity
With this feature, the contract promises, upon the death of the annuitant, to pay to the annuitant's estate or to a designated beneficiary a lump sum that is the difference, if any, between the purchase price of the annuity and the sum of monthly payments that had been distributed up to the primary annuitant’s death.

Example
Lump sum paid $100,000
Payments received $75,000
To beneficiary $25,000

NOTE: The refund is tax-free up to basis.

Two types of refund are available.
  Installment - Payments continue until full cost is recovered.
  Cash - Remaining lump sum is paid (like example above).

Example
Alan is age 40. He is comparing a pure life annuity versus a refund annuity. At younger ages, the difference in the annuity payout would be small due to the high probability of survival. He should purchase the refund annuity.

Joint and survivor (not joint-life)
This annuity's payout is computed based on two lives. Under the joint-and-last-survivor annuity, the insurance company promises to make payments until both annuitants die.

Final note
The pure life (single life) annuity will always have the highest income per dollar of outlay. However, it is not suitable for everyone (no wealth passes to the family).

Applying the Facts
Which distribution option is most appropriate for Bud and Betty Budget, a retired married couple with no other source of income?
A. An interest-only distribution
B. A joint life annuity
C. A single life annuity with a 10-year period certain on the spouse with the longest life expectancy
D. A joint-and-survivor annuity

Answer: D A joint and survivor annuity continues payments through the lives of both annuitants. The joint-life annuity should not be confused with, a joint-and-survivor annuity. Under a joint life annuity, payments cease on the death of the first annuitant. No further benefits are paid.

NOTE: The joint-life annuity may be an incorrect
answer on the exam. It is seldom, if ever recommended.

**Single premium deferred annuity (SPDA)**
The annuity is purchased with a single premium rather than periodic payments. Earnings accumulate tax-deferred until distributed.

**Variable annuity**
An annuity may be variable during the accumulation period and variable during the payout period or fixed during the payout period. Under a variable annuity, premiums are normally invested in a portfolio of mutual fund-like investments (called sub accounts or allocation accounts or separate accounts). Both an insurance and security license are required to sell the variable annuity (or variable life insurance).

### Applying the Facts

1. Tiki Takeexams earned her Series 6 and all applicable state licenses. Which investment can't she sell?
   - A. Variable annuity
   - B. Variable life insurance
   - C. Mutual funds
   - D. REITs

   **Answer:** D  Tiki must have both licenses to do Answers A and B. REITs are tradable securities. She would need a Series 7 license.

2. Tiki is only a limited securities representative (series 6). Which investment can she sell?

   **Answer:** C  She can only sell the mutual funds because she doesn't have an insurance license.

### Suitability of Variable Annuities
Variable annuities are suitable for clients with moderate to high risk tolerance. If wording like "attempt to cope with inflation" or "keep up with market conditions" is used in a suitability question, the variable product (annuity or life insurance) is usually the correct choice.

### C. Taxation of Annuities
For individual taxpayers, investment income earned on annuities during the accumulation period is not taxable until distributed to the contract holder.

**Periodic distribution**
An annuity’s payout can be immediate or deferred. If deferred, the owner is not taxed on the yearly buildup until he either takes a lump sum distribution or periodic payments.

When an annuitant receives periodic payments, the portion of each annuity payment representing a distribution of accumulated earnings is taxed as ordinary income (no 10% penalty). The portion representing a return of the owner's investment (basis) is non-taxable. This is the annuity inclusion/exclusion ratio. An exclusion ratio is applied until the taxpayer recovers his/her entire principal; then the full payment is taxable (see the following example).

### Example
Annie Annuitant purchased an annuity for a single premium of $50,000 10 years ago. This year she began receiving payments of $1,000 per month for the rest of her life. Her life expectancy is 20 years. What is her exclusion ratio?

\[
\frac{$50,000 \text{ investment}}{240,000 \text{ expected return}} = .20833 \text{ excluded} = 20.833\% \text{ excluded}
\]

$208.33 is excluded from taxation, and $791.67 is taxable (ordinary). When the excluded $208.33 payments total $50,000 (240 payments), the whole $1,000 per month then becomes taxable.

Applying the Facts
1. A few years ago Daphne Deferral purchased an annuity for $150,000. It is currently worth $200,000. She will retire at age 68 and annuitize. Presuming a single life expectancy of 16 years and if the annuity pays $1,500 per month, what amount of each monthly payment is taxable?

A. $718.80   C. $458.40
B. $781.20   D. $1,041.67

Answer: A Basis $150,000 ÷ Payout 16 x 12 x $1,500 = $150,000 ÷ $288,000 = .5208 excluded
(1 - .5208) = .4792 included
$1,500 x .4792 = $718.80

2. Elanor’s husband Franklin died, leaving her a death benefit of $100,000 from life insurance. Elanor, age 55, decided to take payment in the form of a single life pure annuity. Interest rates are currently 9%. The payout will be $800 at the end of each month. Her life expectancy is 30 years. How much of each monthly payment is taxable if the basis of the life policy is $50,000?

A. None - Death benefits from a life contract are tax-free.
B. $278 is taxable income.
C. $522 is taxable income.
D. $278 is taxable income, plus 10% early withdrawal penalty applies.
E. $644 is taxable income.

Answer: C Payout $800 x 12 x 30 = $288,000
$100,000 x 800 = $278 (excluded)
$288,000

The difference ($522) is the taxable portion (included portion). This takes into consideration interest (9%) paid on the contract. The $100,000 in life insurance proceeds increases the basis (the investment value) because they are received income tax-free. They also are estate tax-free because they are paid to Elanor through the marital deduction.
3. Ten years ago Samantha purchased an annuity for $100,000. Today, it is worth $180,000. She is now 70 years old. She feels her life expectancy is 20 years. The carrier offers her a lifetime payout of $1,200 per month based on an 18-year life expectancy. How much of the $1,200 will be taxable?

A. $416.64    C. $737.04
B. $462.96    D. $769.36

Answer: C

The tax-free portion is 38.58% ($462.96)
$100,000 basis  $1,200 x 12 x 18 = $259,200
$100,000 ÷ 259,200 = .3858
The taxable portion is 1 - .3858 = .6142
$1,200 x .6142 = $737.04 taxable

A loss deduction can be claimed only if the loss
-- is incurred in connection with the taxpayer’s trade or business or
-- from a transaction entered into for profit.

Examples
A little over a year ago, Len purchased a variable annuity for $100,000. Recently, the value of the annuity has fallen to $76,000, and Len liquidates the annuity. His loss of $24,000 (ordinary income loss) is fully deductible from other income earned by Len in the year of the loss. The transaction was entered into for profit.

A few years ago, Robert purchased a variable annuity for $100,000 for his mother. (She was the owner and annuitant; Robert was the beneficiary.) Later, when his mother dies, he acquires the contract by beneficiary designation ($76,000). If he surrenders the annuity at a loss ($24,000), he will likely not be able to deduct the loss. He entered the contract to help his mother rather than for personal profit.

Taxation of Withdrawals
Contracts issued after August 13, 1982, are taxed LIFO (last in, first out). A withdrawal is taxable interest to the extent that the cash surrender value of the contract exceeds the investment. In addition, withdrawals by contract owners prior to age 59-1/2 are subject to a 10% premature withdrawal penalty on the ordinary income tax.

Example
Harry buys an annuity for $100,000. When the contract value is $150,000, he withdraws $20,000. What is the tax effect?

Answer: $20,000 of taxable interest

If Harry was 55 years old, the $20,000 would be subject to a 10% premature withdrawal penalty in addition to his marginal income tax rate.

Non-natural person
If an annuity contract is held by an entity who is not a natural person (i.e., not an individual but rather a corporation or certain trusts), the annuity taxation rules change. The income on the contract must be treated as ordinary income received or accrued by the holder that year.
Applying the Facts

1. Corporation X offers a nonqualified deferred compensation plan to Jack. The company purchases and owns a variable annuity ($100,000 initial deposit). The accrued gain for the year is 16% or $16,000. How is the annuity taxed?
   A. Annuities are always tax deferred.
   B. Owners of variable annuities pay capital gains tax.
   C. The gain for the year is ordinary income to the corporation.

   Answer: C If an annuity contract is held by an entity that is not a natural person, the income on the contract must be treated as ordinary income by the holder during that tax year.

   NOTE: Although trusts are also not natural persons, there are no test questions on trusts.

2. Corporation X offers a non-qualified deferred compensation plan for Jack. The company purchases and owns a variable annuity ($100,000 initial deposit). The annuity suffers a $5,000 loss for the current year. Is the loss deductible?
   A. The loss is limited to $3,000 (capital loss).
   B. The loss is not deductible.
   C. The loss is an ordinary loss to the corporation.

   Answer: C If income is ordinary income (Question 1), then a loss is an ordinary loss to the corporation.

3. Bob owns a variable annuity. The accrued gain for the year is 16% or $16,000. Is the gain tax-deferred?
   A. The annuity is tax deferred.
   B. Variable annuities pay capital gains tax.
   C. The gain for the year is ordinary income.
   D. The contract must be annuitized before Bob attains age 59½.

   Answer: A This contract is owned by a natural person (Bob). Taxation is deferred.
4. As part of their retirement plan, Bob Yates and his wife Carol purchased a qualified commercial deferred annuity with retirement plan assets. This annuity distributed income to Bob and Carol on a joint and survivor basis. Bob died at age 75, and Carol is now age 72. Which one of the following is a correct statement concerning this commercial annuity?

A. This annuity was probably purchased with after-tax dollars.
B. The amount of the annuity includible in Bob's estate is the amount of the original investment that had not been fully recovered at his death.
C. Since this annuity was part of qualified plan, none of the benefits qualify for the marital deduction.
D. The amount of the annuity includible in Bob’s estate is the replacement cost of a single life annuity on Carol at the time of Bob's death.

Answer: D  Answer D is correct because the amount includible in Bob's estate is the replacement cost of a single life annuity on Carol at the time of Bob's death. Answer A is incorrect because a qualified annuity is often purchased with pretax dollars.

5. When, if at all, are the annual earnings from an annuity tax deferred?
A. Always
B. Never
C. When they are owned by a human being
D. When they are owned by a not-for-profit association

Answer: C  Earnings on annuity contracts are tax deferred when such contracts are owned by “natural persons” (humans).
Applying the Facts:

1. Sam Waters, age 63, will retire soon. His employer provides an endorsement type split dollar policy on his life. Sam has no other life insurance and has been told that if he applied for life insurance he would be rated (increased premium) or declined. His company has informed him that he can purchase the policy now held under the split dollar agreement. What amount would he have to pay?

<table>
<thead>
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<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Universal Life</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>(death benefit)</td>
<td></td>
</tr>
<tr>
<td>Cash value</td>
<td>$120,000</td>
</tr>
<tr>
<td>Premiums paid</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

A. He can purchase the policy by paying $100,000 but it would trigger transfer-for-value income tax consequences.
B. $100,000
C. $120,000
D. $100,000 plus 6% interest*
E. $120,000 plus 6% interest*  
   * His company’s interest charge

Answer: C  
Under the endorsement split-dollar method, he will have to pay the higher of the cash value or premiums paid. The company will enjoy a gain on the premiums paid but generally cannot charge him interest due to typical terms of the agreement.

2. Thirty years ago Sidney Boyd bought a $25,000 single premium deferred annuity. He was age 30 at that time. Now approaching retirement he is trying to decide if he should take the cash value ($110,000) as a lump sum or annuitize the policy over a 20-year single life expectancy receiving $725 per month. When he actually retires his tax bracket will drop to 15%. What would you suggest if he feels he can invest the lump sum and achieve a 6% after-tax return?

A. He should take a lump sum and pay the tax on the amount of the distribution exceeding his basis.
B. If he takes a lump sum, he will have to pay the tax plus a 10% penalty (annuity rules), he should annuitize.
C. He should annuitize the contract under a life income with period certain payout option.
D. He should take a lump sum because all he would receive is 20 years of payments.

Answer: C  
If he takes a lump sum, he will pay 15% on $85,000 ($110,000 - 25,000 basis) or $12,750. Alternatively he can choose a payout with no principal reduction.  
($110,000 - 12,750) x 6% = $5,835/year.  
However, he is not using up his principal.
Or, he could convert $97,250 ($110,000 – 12,750) into a new 30-year annuity at 6% that would generate $6,665, but it would end in 30 years.

But, if he annuitizes…

\[
\frac{25,000 \text{ (basis)}}{12 \times 20} = \frac{25,000}{174,000} = 14.37\% \text{ tax-free}
\]

The policy will continue after 20 years until he dies. However, it will all be taxable. ($725/month)

\[
725 \times (1 - 14.37\%) = 725 \times .8563 = 620.82
\]

\[
620.82 \times 12 = 7,449.84/\text{year}
\]

Answer B is wrong. Because he is over 59½ there is no 10% penalty. Answer D is wrong because the payments continue after 20 years, but then become 100% taxable.

3. Tom, age 58, and Bob, age 35, who are father and son own a corporation together. They will enter into a buy-sell arrangement. Unfortunately, Tom is uninsurable for both life and disability insurance. What type of arrangement can they enter into, if any?

A. None. The Internal Revenue Code disallows buy-sells between family members.

B. Bob should enter into a naked promise to pay if Tom dies or becomes disabled.

C. Bob should enter into an installment sale agreement to buy Tom’s stock from the corporation.

D. Bob should enter into an installment sale agreement to buy Tom’s stock.

Answer: D Tom owns his own stock. An installment sale would allow Bob to buy his ownership over time – in case Tom dies, becomes disabled, or retires. As he purchases Tom’s shares, Bob’s basis increases proportionately.
4. Gale and Susan started a tour bus company many years ago. It operates as a regular C Corporation. They also executed an entity purchase buy-sell funded with life insurance. Gale has decided to leave the business to pursue her dream of becoming an exotic dancer. She is going to sell her stock to Susan. Gale would like to purchase her policy from the corporation for personal use. If the corporation sells the policy to Gale for its value, how can Gale avoid triggering a transfer-for-value?

A. Gale should purchase the policy to avoid transfer-for-value.
B. Susan should buy Gale’s policy and then Susan should gift it to Gale to avoid transfer-for-value.
C. Gale’s husband should purchase the policy to avoid transfer-for-value.
D. The policy should be returned to the insurance carrier and a new policy with Gale as owner will be issued. This would avoid transfer-for-value.

Answer: A The insured can buy her own policy. Without creating a transfer-for-value problem. Answer B and C create transfer-for-value exposure. Answer D is not possible.
Group Life and Disability Insurance

Lesson 9

Group life insurance
A. Types and basic provisions
1) Group term life insurance
The life insurance must meet four conditions.
(1) It must provide a general death benefit which is excludable from gross income.
(2) It must be provided to a group of employees as compensation for personal services performed as an employee.
(3) The insurance must be provided under a policy carried directly or indirectly by the employer.
(4) The amount of insurance provided to each employee must be computed under a formula that precludes individual selection of death benefits.

Applying the Facts
A person is an employee if his relationship to the person for whom the services are performed is that of employer-employee. Whom among the following persons could be excluded for coverage?
A. A person who works for himself (self-employed)
B. A partner in a law firm
C. A 5% owner-employee of a S corporation
D. A commission-only salesperson

Answer: D A commission-only salesperson may not be classified as an “employee.” As long as the self-employed person, partner, or a more than 2% S corporation-shareholder performs services for the employer, he/she is not excludable. A full-time life insurance salesperson who is classified as an employee for Social Security purposes will be considered an employee for group term insurance coverage.

2) Group permanent life insurance (nonforfeitable)
A group permanent policy does not meet the requirements to be treated as group term life insurance. The employee will be taxed (W-2 income) on the premiums paid by the employer if the proceeds are payable to the beneficiary named by the employee. The premiums are deductible by the employer.

3) Dependent coverage
Group term coverage on the lives of the employee's spouse and dependents is not included in the $50,000 exemption. However, the cost of such coverage will be income-tax free if the face amount does not exceed $2,000. Above $2,000, employee pays tax on the premium.
Applying the Facts
Can an employee's spouse obtain more than $2,000 group term coverage?
A. Yes
B. No

Answer: A Yes, an employee's spouse may be covered for more than a $2,000 death benefit, but only $2,000 can be a tax-free employee benefit.

B. Income tax implications
Group term life insurance is a benefit provided by an employer to a group of participating employees. An employee is generally not taxed on premiums paid by the employer if the employee's total coverage doesn't exceed $50,000. If the total coverage exceeds $50,000, he is taxed on the cost (Table 1) of coverage over $50,000 minus the amount he paid. The employer must compute the cost of taxable group term coverage and notify the employee on Form W-2 of the amount included in his income. The premium is deductible by the employer.

Applying the Facts
1. Scott’s employer provides him with $250,000 of group term life insurance. For this coverage, Scott contributes $.20 per $1,000 of coverage per month. What amount is included in Scott's income if the Table 1 rate is $.43 per $1,000 of coverage per month?
   A. $36
   B. $250
   C. $432
   D. $552
   E. $690

Answer: C Monthly cost $.43 x 200 = $86
Contribution $.20 x 250 = -50
$36 X 12 = $432

The contribution is based on the whole face value of $250,000, but the first $50,000 of coverage is income tax free. Scott’s W-2 will show the annual amount not the monthly amount. If you included $250,000 to calculate the monthly cost, you would have chosen answer E. If you factored $200,000 for the contribution, you would have chosen Answer D.

2. Is the taxable income from Question 1 subject to FICA or self-employment tax?
   A. No, the plan is an employee benefit.
   B. Yes, it is subject to FICA.
   C. Yes, it is subject to self-employment tax.

Answer: B The income is W-2 compensation subject to FICA and FUTA taxes. The insured is an employee of the company (not a self-employed person).

Discriminatory group life plans
The exclusion of the first $50,000 is available to a key employee only if the plan does not discriminate in favor of key employees as to eligibility to participate and in the type/amount of benefits. If the plan is discriminatory, each key employee must include the
greater of the actual cost of insurance or the cost determined from Table 1 (annual basis). Benefits will be considered discriminatory unless all benefits available to key employees are available to all other participants. The non-key employees retain the $50,000 exclusion even in a discriminatory plan.

Applying the Facts
Esther, age 45, earns $100,000. She is eligible for 5 times annual income in group life insurance. Non-key employees are only eligible for 1 times annual income. If the Table 1 rate is $.15 per $1,000 per month, how much income is Esther charged for this benefit?

A. $75  C. $600  
B. $180  D. $900

Answer:  D  \(0.15 \times 500 \times 12 = $900\) In a discriminatory group term policy, the key employees lose their $50,000 exemption. There is no effect on non-key employees.

Group permanent life insurance
The employer can deduct the premiums only if the employee's right to the insurance on his life is nonforfeitable. If the employee has only a forfeitable right to the insurance, the employer cannot deduct the premium payments.

C. Employee benefit analysis and application
Group life insurance is usually offered as a flat amount for all employees (typically $50,000) or as a multiple of salary. Although the employer owns the policy, the employee names the beneficiary. The ability to name the beneficiary causes the death benefits to be included in the employee's estate.

Assignment of group term life
It is possible for an employee to assign all incidents of ownership in a group term policy. Incidents of ownership include the right to name or change the beneficiary, the right to convert the policy, and the right to terminate the coverage. If the employee completes an absolute assignment during his or her lifetime (gives up all rights), he or she will be deemed not to have retained any incident of ownership. After three years, the death benefits will be excluded from his or her estate.

D. Conversion analysis
Any employee whose group life insurance coverage ceases has the right to convert to an individual life insurance policy. The conversion does not require proof of insurability. Conversion can be made to any type of permanent plan. The premium will reflect the insured’s age at the conversion.

Applying the Facts
Larry Holmes works for ABC, Inc. He has group life coverage of $200,000. If he terminates his employment with ABC, what are his options if he is now un-insurable?

A. He can convert to a 20-year term insurance policy  
B. He can continue the group life coverage  
C. He can convert to a $250,000 ordinary life insurance policy  
D. He can convert to a $200,000 universal life insurance policy
E. Carve-out plans
Under a group carve-out plan an employer removes or “carves-out” one or more highly-compensated employees from the life insurance coverage provided by a group term life insurance policy. The “carved-out” employees are provided life insurance coverage through individual policies. Low term insurance rates on individual policies and lower minimum premiums on permanent policies contribute to the popularity of this type of plan. Also, the portability of the individual policies makes this arrangement attractive to the highly compensated executives who are typically selected to participate.

Currently, the purchase and ownership of the individual life insurance policies is often structured as the following.
- Split dollar
- IRC Section 162 bonus plan (covered below)
- DBO (Death Benefit Only) arrangement (covered in Lesson 10 – Retirement Planning)

IRC Section 162 bonus plan
The employee purchases and owns the life insurance on his or her life. The employer pays the premiums to the insurance company. The premiums are fully deductible to the employer as compensation to the employee under IRC Section 162. The premiums are a “bonus” and thus taxable income (W-2) to the employee and the employee owns the life insurance policy including policy values.

The employee must pay the income tax on the premium with no cash (phantom income). Thus, a second bonus (162 double bonus) is generally paid to the employee to cover the tax.

Group disability plans
A. Types and basic provisions
   1) Short-term coverage
   2) Long-term coverage

Group policies tend to be less expensive than individually issued ones and require simpler underwriting than individual policies. However, they are likely to carry dual definitions of disability and other restrictive provisions. Short-term and long-term policies are available. Short-term may start as soon as 1st day accident or 8th day sickness and last 13, 26, or 52 weeks. Limited benefits are paid weekly. Long-term benefits can start at 30 days to 2 years and last until age 65. Benefits are paid monthly. Long-term benefits are usually limited to some cap such as 50% of compensation, or a dollar maximum of $5,000 per month.
B. Definition of disability
For short-term policies, the weekly benefits are very limited, it is not unusual to have a more liberal definition (cannot work) in the policy.

The typical definition of total disability in a long-term policy is 2-5 years of own-occupation and thereafter modified any-occupation.

C. Income tax implications
Generally, the employer pays 100% of the premium (noncontributory). The employer deducts the premium. Disability benefits received by the employee are considered taxable income. Under a partially contributory plan, a portion of the premium is paid by the employee. Taxation is based on the ratio of employee contributions to total premiums paid.

Applying the Facts
Sandy works for B & B Interiors. The company has a contributory long-term group disability policy. Sandy’s benefits under the policy are $3,000 per month. If she contributes 50% of the premium due each month, what happens if she becomes disabled?
A. She will only receive $1,500 of benefits tax-free.
B. She will receive $3,000 of benefits.
C. She will receive $3,000 of benefits. 50% will be taxable, and 50% will be tax-free.
D. She will receive $1,500 of benefits tax-free, and the company will get $1,500 of benefits (taxable).

Answer: C Sandy is paying for half of the premium with after-tax dollars. Half the benefits she receives will be tax-free. The other half is taxable (to her - not the employer).

D. A Strategy to Maximize Coverage
Insurance carriers will normally issue a disability policy that provides 50-60% of earned income. One way for an individual to obtain more coverage is to first purchase an individual policy before enrolling in a group plan. Once the individual plan is in place, the carrier cannot reduce benefits due to other disability coverage. The individual disability coverage does not affect the group benefits. In this way an individual could obtain disability benefits approaching 100% of earned income.

E. Integration with other income
Group disability insurance policy benefits generally, but not always, coordinate with Social Security disability benefits. Disability benefits received from Social Security generally reduce group disability insurance benefits.

Social Security disability coverage
The definition of disability requires a mental or physical impairment that prevents the worker from engaging in any substantial employment. Disability benefits are subject to a 5-month waiting period and are payable beginning with the sixth full calendar month of disability. However, the disability must also have lasted or be expected to last at least 12 months or result in death.
Applying the Concept
Professor Nutty was employed at State University. He earned $40,000 per year. The university funds a disability policy (180-day elimination period) to replace 60% of his income. The policy is coordinated with Social Security disability benefits should the situation arise. In addition, he has a financial consulting practice that brings in $30,000 in net schedule C income. He purchased an individual disability policy (90 day wait) based on 60% of his consulting practice income (with no Social Security coordination). Assume Professor Smith is totally and permanently disabled and is awarded $800 per month disability payments from Social Security. What will be his gross benefit in the 5th, 6th, and 7th month from all three sources?

A. $1,500; $1,500; $2,300
B. $1,500; $2,300; $3,500
C. $2,300; $2,300; $3,500
D. $2,300; $2,300; $4,300

Answer: B Payments would be $1,500 for his individual policy for month 5 and then an additional $800 from Social Security for month 6 ($2,300). The $2,000 benefit from the university would be offset by Social Security payments in the 7th month or a net of $1,200 more ($3,500 total).

Month 5 $30,000 X 60% = $18,000/yr. or $1,500 per month
Month 6 Awarded $800 per month Social Security benefits
Month 7 $40,000 x 60% = $24,000/yr. or $2,000 per month, but this is offset by the $800 from Social Security. The result is $1,200 more in benefits.

Note: Social Security requires a 5-month waiting period. There are no benefits until the 6th month.

Applying the Facts
1. Company X purchases a group term life insurance policy on each of its employees for $100,000. It is the owner and names itself as beneficiary of the policy. Can the company deduct the premium?
A. Yes
B. No, only for the first $50,000 of coverage
C. No, not unless it charges each employee for the cost of insurance in excess of $50,000
D. No

Answer: D No deduction will be allowed for the cost of coverage on the life of an employee, if the employer is directly or indirectly the beneficiary under the policy.
2. Lou Long is an employee of Company X. The company has just paid the full premium and deducted the premium on a whole life policy on Lou’s life. The insurance policy is owned by Lou and Lou’s wife is the primary beneficiary. What type of arrangement does this appear to be?

A. Collateral assignment split dollar policy
B. IRC Section 162 policy
C. Endorsement method split dollar policy
D. Entity purchase buy-sell policy
E. Group term policy

Answer: B

Company X (the employer) paid the premium, then “gave” the policy to Lou. This is a Section 162 (Bonus) arrangement. Answer A is wrong because with collateral assignment Lou would be the owner. But Lou is not an owner, he is an employee. In a split dollar arrangement (answers A and C), the company cannot deduct the premium. In answers C and D, the company is the owner. Answer E is not a whole life policy, it is group term. Answer B can be whole life, universal, or variable universal.
Other Employee Benefits

Lesson 10

Other employee benefits
A. Section 125 cafeteria plans and flexible spending accounts (FSAs)

Cafeteria plan
A cafeteria plan permits employees, within limits, to choose the form of employee benefits they want from a "cafeteria" of benefits provided by their employer. Cafeteria plans must include a "cash option" – an option to receive cash in lieu of non-cash benefits of equal value. Examples of a cafeteria plan choices include the following:
– term life equal to 2 times salary
– medical insurance for employee
– short or long-term disability insurance

Note: A 401(k) arrangement can be offered under a cafeteria plan.

Flexible spending account (FSA)
An FSA is a cafeteria plan under rules found in Code Section 125. It may not discriminate in favor of highly compensated employees. The most common type of FSA is used to pay for medical expenses not covered by insurance. Distributions usually cover deductibles, co-payments, and coinsurance for the employee’s health plan, but may also include expenses not covered by the employer’s health plan, such as dental and vision expenses. Most cafeteria plans offer two different flexible spending accounts; one is for qualified medical expenses and the other is for dependent care.
NOTE: Over-the-counter drugs are no longer available.

Health FSA
Before the end of the prior calendar year, employees file a written election with their employer to reduce their salaries by the amounts they choose by any amount for the health FSA and allocate them among the benefits in the plan. The dollar limit, to be effective for tax purposes, must be made before the compensation is earned. The reductions are not subject to income tax, FICA, or FUTA. Each employee keeps receipts of expenses in each benefit category and submits them to the plan for reimbursement.

• Employers may adopt retroactive amendments to impose the $2,750 limit before Dec. 31, 2020.
• The $2,750 limit applies only to salary reduction contributions under a health care FSA and does not limit the amount permitted for reimbursement under an FSA for dependent care assistance or adoption care assistance.
• The $2,750 limit also does not apply to employer non-elective contributions — sometimes called flex credits — nor to salary reduction contributions to a cafeteria plan that are used to pay an employee’s share of health coverage premiums.
• In the case of a plan providing a grace period (which may be up to two months and 15 days), unused salary reduction contributions to the health care FSA that are carried over into the grace period for that plan year will not count against the $2,750 limit for the subsequent plan year.
• A recent rule also permits health FSA participants to maintain a $500 balance in their FSA accounts indefinitely.
NOTE: The employer may offer only one of the options: no grace period, the 65-day grace period, or a $500 rolling balance.

Applying the Facts
1. What are similarities and differences between FSAs and HSAs?
   I. FSAs are used for medical reimbursement but also dental and vision, but HSAs are for medical only
   II. Unused FSA funds may be lost when the plan year is over, whereas HSA unused amounts remain the property of the HSA owner.

   A. I     C. II
   B. I and II  D. Neither I nor II

   Answer:  C  HSA medical expenses include medical reimbursement, dental and vision.

2. What happens if a participant uses an FSA debit card to pay for outpatient drugs?
   I. Pharmacies and grocery stores can choose to accept the card but must disallow transactions at the point of sale for over-the-counter drugs.
   II. Employer must require employees to provide itemized receipts for all expenses charged to the debit card

   A. I     C. II
   B. I and II  D. Neither I nor II

   Answer:  B  The IRS also allows employers to waive the receipt requirement when an individual uses the debit card at a pharmacy or grocery store that accepts the FSA debit card.

Dependent care FSA (unchanged for 2020)
The maximum tax-free reimbursement under an FSA is $5,000 per year. Any tax-free reimbursement from the account reduces the expense eligible for the dependent care credit. If the participant is married, both spouses must earn income in order for the dependent care FSA to be available. The only exception is if the non-earning spouse is disabled or a student. If one spouse earns less than $5,000, then the benefit is limited to whatever the spouse earned.

Example
If Lance elects to withhold $5,000 for childcare expenses and is married to Pam, a non-working spouse, the $5,000 would become taxable. If Lance did not submit claims by the required date (also December 15th), the $5,000 would be forfeited to the employer and the person forfeiting it still pays taxes on it.
When are expenses eligible for reimbursement from a DCFSA? (Dependent Care FSA)
The DCFSA can pay eligible expenses for care of a participant’s dependent children under age 13, or for a person of any age whom the employee claims as a dependent on the federal income tax return and who is mentally or physically incapable of caring for himself or herself. Expenses can be reimbursed only after they have occurred.

Examples of eligible services:
- Placement fees for a dependent care provider, such as an au pair (domestic assistant working for, and living as part of, a family)
- Before and after-school care (other than tuition)
- Care of an incapacitated adult who lives with you at least eight hours a day
- Childcare at a day camp, nursery school, or by a private sitter
- Late pick-up fees
- Expenses for a housekeeper whose duties include caring for an eligible dependent
- Summer or holiday day camps, including registration fees
- Activities in lieu of day care when the fees associated with the activity are incidental to, or cannot be separated from, the cost of care (swimming lessons, arts, and crafts, music lessons, etc.)

What expenses are NOT eligible for reimbursement by a DCFSA?
Examples of ineligible DCFSA expenses:
- Tuition and fees
- Expenses for children age 13 and older
- Late payment fees
- Overnight camps
- Payment for services not yet provided (advanced payments)
- Field trips, clothing and food
- Transportation to and from the dependent care provider

Applying the Facts
1. A dependent care FSA can cover expenses for which of the following?
   A. Dependent care for a child under age 13
   B. Dependent care for a mentally dependent spouse
   C. Dependent care for a physically dependent adult
   D. Answers A, B, and C

   Answer: D Dependent care assistance can be provided through an FSA only to (a) a child under 13 or (b) a taxpayer's dependent or spouse who is physically or mentally unable to care for himself or herself.
2. Mike is considering adopting an FSA if his consulting partnership simultaneously adopts an HSA. What benefits or options are available from an FSA?
   I. Dependent care (maximum of $5,000 per dependent) and long-term care
   II. Deferred compensation and life insurance
   III. FSA contributions can be made to a HSA, and the partnership can save FICA & FUTA taxes on the contributions to the FSA (and HSA).
   IV. Medical expense FSA benefits (but not HSA benefits) can continue under COBRA if a triggering event occurs and can allow the participant to avoid the 7½% AGI floor that otherwise limits itemized deductions for medical costs.

   A. I, II, III  
   B. I, IV  
   C. III, IV  
   D. All the above

   Answer: C

   Answer I is incorrect because the dependent care limit is $5,000 per year per employee, not per dependent. Answer II is wrong because deferred compensation is not available under an FSA. Life insurance is not available under an FSA. FSAs may offer medical expense benefits without establishing an HSA.

3. Which of the following types of deferred compensation arrangements can be included in a cafeteria plan?
   A. SARSEP (Salary Reduction Simplified Employee Pension plan)
   B. SIMPLE
   C. 401(k) - profit sharing plan with match
   D. 457 - governmental

   Answer: C

   The only type of retirement plan that can be part of a cafeteria plan is a 401(k).

4. Larry Jones, a widower, has two children. He elected that $5,000 be allocated to his dependent care under his FSA. He allocated $5,000 out of his January paycheck into the account and used $420 the first month. On February 1st he marries Jennifer Young. She is a stay-at-home mom and will take care of two young children. What happens to his dependent care fund?
   A. The remainder is refunded to him.
   B. He loses the remainder.
   C. He will have to take the remainder as compensation.
   D. He should not have gotten married.
Answer: B If a single person elects to withhold $5,000 for childcare expenses and then gets married to a non-working spouse, the $5,000 would become taxable. If this person did not submit claims by the required date, the $5,000 would be forfeited but taxes would still be owed on the amount.

5. Under which type of plan, FSA or HSA, can premiums be paid for LTC and COBRA?
I. FSA
II. HSA

A. I
B. II
C. I and II
D. Neither I nor II

Answer: B FSAs cannot be used to reimburse employees for premiums paid for HSAs and COBRA (see 10-1), but HSAs can.

Coverage Period
An FSA’s coverage period ends either at the time the “plan year” ends for your plan or at the time when an employee’s coverage under that plan ends. Example: Loss of coverage due to a separation from the employer.

For example, if Sue is employed by a company from January through June and covered on their cafeteria benefits plan (including FSA) during that time, but does not elect and pay for continued coverage under that plan (i.e. COBRA), her coverage period is defined only as January through June, not January through December. In this example, all covered expenses must be incurred between January and June of that year.

Advantages and disadvantages:
One consideration regarding medical FSAs is that the participating employee’s entire annual contribution is available at the start of the plan year, commonly January 1, or after the first contribution to the FSA is received. Therefore, if the employee experiences a qualifying event during the first period, the entire amount of the annual contribution can be claimed against the FSA benefits. If the employee is terminated, quits, or is unable to return to work, he does not have to repay the money to the employer. The employee contributes to the FSA in small increments throughout the year (for example, 1/26 of the annual amount presuming bi-weekly salary), but taken together, all employees of a company contribute the full average amount during any given period, and no risk is incurred by the employer. In addition, instead of paying payroll taxes, the employer typically pays only a small administrative fee to the plan of $4-$10 per participating employee (much less than payroll taxes). In addition, any money that is not used by the end of the plan year (or grace period) is returned to the employer and may be used to continue the FSA plan.

An employee does not continue to contribute to the plan upon termination of employment. A worker, could use the entire amount on day one of the plan year, terminate employment on day two of the plan year, and contributions would have been negligible. The “free” money is not taxable because the IRS views these plans as health insurance plans.
Any money that is left unspent at the end of the coverage period is forfeited and can be applied to future plan administrative costs or can be equally allocated as taxable income among all plan participants. Under most plans, the “coverage period” generally ceases upon termination or employment whether initiated by the employee or the employer, unless the employee continues coverage with the company under COBRA or other arrangement.

B. Fringe benefits

The Tax Relief Act of 2001

An employee and spouse may exclude from their income the value of certain retirement planning services provided by the employer maintaining their qualified retirement plan. The services may include general advice regarding the employee's and spouse's overall plan for retirement of which the employer's qualified plan is only a part.

Fringe benefits–tax free-2020

– Premiums the employer pays to a health plan for the employee, spouse, or dependents
– Insurance premiums paid by the employer on a group life policy of up to $50,000 on your life
– Value of qualifying day care services provided by the employer (limited)
– Company car for only business purposes
– Commuter highway vehicle and transit passes ($270/month cap – 2020)
– Employer-provided parking spots or subsidized parking ($270/month cap - 2020)
– Occasional overtime meal money, cab fare, theater, or sporting event tickets
– Value of discounts on company products if it does not exceed the employer's gross profit percentage
– Discounts on services limited to 20% of the selling price charged customers or patients

Fringe benefits – taxable

– Health insurance premiums paid for self-employed individuals, partners, and more than 2% owners of an S corporation. However, 100% is deductible as an adjustment to income on the front of the 1040. This can include all types of health insurance programs but not disability insurance premiums.
– Employer-paid insurance premiums on a group life policy in excess of $50,000 of death benefit if the plan is nondiscriminatory (per Table I).
Applying the Facts
Amahl Animalover owns a successful veterinary practice. It operates as an LLC, has given you a list of employee benefits. Which of the following perks can he provide tax-free to the employees of the practice?

I. $190 per month for parking (Office is in a downtown building.)
II. Occasional theater tickets
III. 50% off on medical care for pets
IV. $100,000 group life insurance
V. Group disability insurance up to 50% of salary

A. I, II, IV, V   C. II, III   E. V
B. I, II, V   D. III, V

Answer: B The excludable amount with respect to services is limited to 20% of the price at which the practice offers services to non-employee customers.

C. Voluntary employees' beneficiary association (VEBA)
Employers may establish a VEBA to fund certain benefits for its members. Benefits can include the following.
-- Death benefits (may also be used to pre-fund retiree death benefits)
-- Medical expense benefits (may also be used to pre-fund retiree health coverage under FASB)
-- Disability benefits
-- Legal expense benefits
-- Unemployment benefits
-- Child care benefits
-- Severance benefits
-- Education benefits

Contributions (within limits) are a deductible expense for the employer.

Applying the Facts
Which of the following benefits generally may not be included under a VEBA?
A. Deferred compensation   C. Legal expenses
B. Unemployment benefits   D. Disability benefits

Answer: A VEBA offerings may not include any benefit that is similar to a pension or annuity at the time of mandatory or voluntary retirement.

D. Prepaid legal services
A legal service plan is an employer-funded plan that makes legal services available to employees. The expense of the plan is deductible by the employer. **Benefits are generally taxable as compensation to the employees.** Individually purchased plans would be paid for with after-tax dollars, but the benefits are tax-free.

E. Group long-term care insurance
Long-term care insurance is not a qualified benefit under a cafeteria plan. However, long-term care insurance premiums may be paid through an HSA included in a cafeteria plan.
Applying the Facts

Group long-term care coverage differs from individual LTC care in which of the following ways?

A. Individuals typically have more choice in amount and duration of benefits than employees would get under a group plan.
B. The per person cost of group coverage is usually more than the cost of individual coverage because individual plans are subject to medical questionnaires.
C. Individual underwriting is less stringent than that for group underwriting.

Answer: A Group benefits are normally selected by the employer and would apply to all covered employees. Both plans require medical questionnaires which makes Answers B and C debatable.

F. Dental insurance

Most dental insurance coverage is written on a group basis (deductible by the employer). The benefits are tax-free like other health insurance benefits.

Types of plans
– Indemnity
– Managed care

Plan benefits can vary from basic benefits (for example, no orthodontic care) to a wide range of dental services.

G. Vision insurance

The premiums for the plan are deductible by the employer. Benefits per a schedule (such as eye examination $50) are generally taxable as compensation to the employee.

Applying the Facts

1. Under which of the following employer provided plans will the employee receive tax-free benefits?
A. Dependent care under an FSA
B. Prepaid legal plan paid for by the employer.
C. Individual disability plan paid for by the employer.
D. Group disability plan paid for by the employer.

Answer: A The employer receives no deduction for FSA contributions, which generally come from employee salary reductions. Under answers B, C, and D the benefits are taxable to the employee because the employer deducted the premium.
Special NOTE on employer paid long-term benefits [Code Section 106(c)]
Gross income of an employee shall include employer-provided coverage for qualified long-term care services to the extent that such coverage is provided through a flexible spending or similar arrangement. In that light it is unlikely that a FSA will support long-term care benefits.

Applying the Concepts: John Silvers Case

1. John Silvers is 35 and married. He works as a middle manager for Juan in a Million Imports Inc. earning a current salary of $120,000. His wife, Linda, is the principal of a private elementary school earning $80,000 in the current tax year. They have two children, Amy, age 6 and Arnie, age 8. The children require care after school. The annual cost of the care is $4,000. The Silvers, who file jointly, are in the 24% marginal income tax bracket. Under its cafeteria plan, John’s employer offers both a dependent care FSA and a medical expense FSA. Would you recommend that John contribute to the dependent care FSA or claim the dependent and childcare credit?
   A. Contribute $4,000 to the dependent care FSA
   B. Claim the child and dependent care credit at 20% of their expenses.
   C. Claim neither child and dependent care credit nor contribute to the dependent care FSA because neither strategy will lower their federal income tax exposure.

Answer: A If John contributes $4,000 to his employer’s dependent care FSA, the Silvers save both income and FICA tax on the contribution as follows:

$4,000 x .24 = $960

+$4,000 x .0765 = $306

**Total** $1,266

Alternatively, claiming the child and dependent care credit of 20% of their annual $4,000 in childcare expense produces a tax savings of only $800.
2. Case continues: John (\$120,000 salary) is covered under an employer-provided group disability insurance plan. The company is paying the premium.

<table>
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<th>Group Disability</th>
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If John is disabled for 9 months during the year, how much of the benefit will be subject to federal income tax?

A. $0
B. $1,400
C. $5,000
D. $8,400
E. $30,000

Answer: E Because the employer is paying the premium, the benefit is entirely taxable.

\[
\begin{align*}
\text{Benefit} & = \frac{\text{Salary}}{12} \\
& = \frac{\$120,000}{12} \\
& = \$10,000 \\
\text{Benefit Period} & = \frac{50}{100} \\
& = 0.50 \\
\text{Elimination Period} & = 90 \text{ days} \\
& = 6 \text{ months} \\
\text{Taxable Benefit} & = \text{Benefit} \times \text{Elimination Period} \\
& = \$10,000 \times 0.50 \\
& = \$5,000 \times 6 \\
& = \$30,000
\end{align*}
\]

3. Case continues: Should John elect a health FSA salary reduction if he and his family expect to incur \$5,000 of health, dental and vision expenses that are not covered by insurance?

NOTE: John and Linda file a joint 1040 return and itemize. Medical expenses are subject to 7 1/2% of AGI in 2020.

A. Yes, contributing \$2,750
B. Yes, contributing \$5,000
C. No, he would be better off to itemize
D. We would need to learn their current year AGI

Answer: A John and Linda’s combined earnings are \$200,000. There is nothing to indicate their AGI is much less than their gross income. In that case, 7 1/2% of \$200,000 would be around \$15,000. This means that none of the \$5,000 would be deductible. The \$2,750 FSA contribution would reduce income taxes and FICA taxes and may be a tax-free distribution. The remaining \$2,300 will not be deductible. Contributions to medical expense FSAs are limited to \$2,750 (2020).
4. Case continues: If Linda is a highly paid employee at The Private School and the employer offers her a group term life insurance benefit of 4 times salary ($80,000), how would this premium benefit be taxed?
   A. Per the Table I coverage cost on $270,000 of death benefit as ordinary income.
   B. Per the Table I coverage cost on $270,000 of death benefit as compensation income.
   C. Per the Table I coverage cost on $320,000 of death benefit as ordinary income.
   D. Per the Table I coverage cost on $320,000 of death benefit as compensation income.

Answer: D This is discriminatory group life (loss of tax-free treatment on the premium for first $50,000 of coverage) as compensation (W-2 income) and 7.65% FICA tax.

NOTE: Ordinary income, like interest, dividends and capital gains are not subject to FICA or self-employment taxes. Compensation is subject to FICA or self-employment taxes.