An Introduction to Life Insurance | A White Paper by Manning & Napier

Introduction

Life insurance is a financial tool that can help individuals accomplish a variety of financial goals. The most common use of life insurance is to provide for dependent family members in case of premature death. Life insurance can also be used to fund certain goals, such as a child or grandchild’s future college expenses. As an estate planning tool, life insurance can help pay federal and state death taxes as well as estate settlement costs. The ultimate gift can be given using life insurance by transferring wealth between generations and making charitable bequests.

In order to properly utilize this powerful tool to help an individual reach his/her financial goals, it is important to understand the methods for determining how much insurance is appropriate in a given situation, as well as the various types of policies and riders available. This paper is designed to offer insight into how to calculate an individual’s insurance need, discuss the different types of insurance, and identify how each type of insurance can best help an individual accomplish particular goals or objectives. This paper is not intended to provide advice, but rather general education. Investors should consult with a qualified tax, legal, and insurance professional before purchasing any insurance products.

Assessment

Using comprehensive financial data and an individual’s goals and objectives, an appropriate amount of insurance can be derived which may allow an individual to achieve their planning goals. Because each person’s situation is unique, each case must be approached with the individual’s goals and objectives as the driving force behind assessing the insurance need. There are three main ways to calculate an individual’s insurance need.

Rule-of-Thumb Approach

This method of calculating an individual’s insurance need is the most basic and it focuses on how much insurance coverage a family needs to replace a breadwinner’s earnings and maintain their standard of living. The general idea is that insuring for an amount equaling six-to-eight times an individual’s annual salary will provide adequate coverage in most situations. A couple of variations to this approach can be used that may provide a more accurate calculation:

• Multiply the gross income of the breadwinner by five and add in mortgage, debts, final expenses and other special funding needs (i.e., college expenses).

• Spend an amount on annual insurance premiums equal to 6% of the breadwinner’s gross income plus an additional 1% for each dependent.

While this approach can provide a basic estimate of the insurance need, it does not take into account individual circumstances, such as the insured person’s age, if the home is a one or two income household, and the age of the dependents.

Income Replacement Approach

This approach uses the human value life concept to measure an individual’s insurance need. The method states that the economic value of a life is the present value of the future earnings potential of that person. Therefore, the amount of insurance needed will equal how much the insured person will earn until retirement. This amount is based on a number of factors including current after-tax income, income growth rates, an after-tax discount rate (or expected future investment returns), and the remaining number of years the insured is expected to work. There are several potential adjustments to an individual’s income level that should be considered in order to calculate an accurate insurance need:

1. The current income value used should be adjusted downwards due to the fact that self-maintenance expenses are not included in the portion of salary spent supporting the family, meaning any money spent on the insured will not be needed to support the family because the insured is deceased.

2. The cost for insurance premiums is not used to support the family and therefore once the insured is deceased those premiums will no longer be paid and should also be excluded from the annual income amount.

3. The future income provided by social security survivor benefits should also be taken into account when calculating how much income is needed to maintain the family’s current standard of living.

The result of this approach will provide an insurance estimate based on the income of the insured that is spent on the family, taking into account income growth rates, discount rates, the working lifetime of the insured, and the insured’s number of dependents.
Needs Approach
The Needs Approach is another simple formula that can be used to calculate an individual’s life insurance needs based on several calculations.

- Sum all of the individual’s short-term needs which likely fall into three categories; final expenses (funeral, attorney, probate), outstanding debts (credit card, auto loan, college loans), and emergency expenses (medical, auto/home repairs).
- Calculate all of the individual’s long-term debts and obligations, such as mortgage and college tuition expenses using the future value of money equation.
- Calculate the family maintenance expenses (i.e., living expenses), which include necessities such as food, clothing, utility bills, and transportation using the future value of money equation.
- Calculate what resources an individual has to meet their needs. Resources include all available savings, stocks, bonds, mutual funds, and existing life insurance policies.

The remaining amount when resources are subtracted from income needs is the amount of life insurance an individual should consider. This number may be altered by eliminating any unnecessary expenses.

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\text{Insurance need} = (\text{Short-term needs} + \text{Long-term needs} + \text{Maintenance Expenses}) - \text{Resources}
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In general, this analysis should be done at least every three years, or when there is a major life change (i.e., birth of a child, purchasing a home, etc.).

Policy Types
Once the amount of insurance needed is calculated, the individual must then decide which type of insurance policy best suits their needs. There are two basic types of life insurance policies, Term Insurance and Permanent Life Insurance, each available in various policy structures.

Term Insurance
These policies will pay a death benefit only if the insured dies within the policy’s term. Term Insurance has no investment or cash value component. Since it is a temporary contract, some of the circumstances in which these policies are useful are when the need for life insurance is temporary, such as a mortgage being paid off or children finishing college. Term Insurance is also appropriate when the need is long-term, but cash flows are insufficient to pay the larger permanent insurance premiums. If an individual has a better investment opportunity for the money he/she will spend on whole life premiums, he/she can buy a term policy for lower premiums and invest the difference. In this case the individual will be insured and can pursue the alternative investment.

Advantages
- Term Insurance allows policyholders the largest amount of coverage for the least expensive premiums
- Conversion features on renewable (i.e., the right to renew a term contract each year for a set amount of years without proof of insurability) and convertible (i.e., the right to convert a term policy to a whole life policy without evidence of insurability) term allow for higher death benefits now and the option of switching to a whole life policy when the ability to pay premiums increases
- Life insurance proceeds are paid out directly to the beneficiary, unless an estate is named, and are not subject to the probate process
- Life insurance proceeds are generally not subject to federal and state income taxes
Disadvantages

- The insurance is only good for the term of the contract, not the life of the insured
- Term policies will become more expensive as an individual gets older
- There are generally no living benefits which could be used to pay the medical expenses and debts of someone diagnosed as terminally ill out of the death benefit, as there is with some permanent policies
- Term Insurance has no tax-free, automatic savings feature found in most permanent coverage

Permanent Life Insurance

Permanent Life Insurance policies combine insurance with investment products and are designed to provide the insured with lifetime protection. They are more expensive than Term Insurance policies because as an individual gets older, the risk to the insurance company rises. One feature of Permanent Life Insurance policies not found in Term Insurance policies is the cash value, sometimes referred to as the cash surrender value. In the beginning of the policy the premium amount will be higher than the actual cost to insure the person. As a result there is an excess amount paid which is then deposited into a separately maintained account for the insured that can grow over time. If a policy is cancelled, this cash surrender value is generally returned to the insured.

There are generally some additional fund fees associated with Permanent Life Insurance, usually in the form of loads, either front-end or back-end. In a front-end fee structure, the initial payment is charged with the fee allowing less of the premium to be deposited into the individual's cash surrender account. Back-end fees will be assessed upon the distribution of the monies within the policy. Some companies offer no-load policies, although they typically do charge some expenses, such as a premium tax.

There are several reasons one would prefer Permanent Life Insurance to Term Insurance.

- It can eliminate the problem of future insurability. Permanent Life Insurance does not expire after a certain period of time. Also, some policies contain guaranteed purchase options, which allow an individual to buy additional coverage at specified times, regardless of his/her health.
- Despite higher initial premiums, Permanent Life Insurance may result in lower total premium payments over the long-term. Most permanent policies are eligible for dividends (which are not guaranteed), if and when they are declared by the insurance company. Many companies offer the option to apply current and accumulated dividend values towards payment of all or part of the premiums. If dividend values are sufficient, out-of-pocket premium payments may end or be reduced after several years, yet coverage can continue for life. Therefore, while premiums must be paid under both the Permanent Life Insurance and Term Insurance plans, long-term out-of-pocket costs of Permanent Life Insurance may be lower compared to the total cost for a Term Insurance policy.
- Permanent Life Insurance builds cash value. This amount (part of which is guaranteed under many policies) may be used in the future. Generally, if an individual would like, he/she can borrow against the cash value for a down payment on a home, to help pay for their children's education, or to provide retirement income (although, borrowing against the cash value from the policy requires the payment of loan interest and will affect the total policy values). Additionally, if an individual decides to stop paying premiums and surrender his/her policy, the cash value may be distributed to them. There may be some fees and taxes associated with this distribution.

There are several different types of Permanent Life Insurance policies, each possessing different features designed to best suit the needs of the insured.

Ordinary Level-Premium Whole Life Insurance

This is the oldest and most common type of Permanent Life Insurance. Ordinary Level-Premium Whole Life Insurance has the basic features and fee structures previously mentioned. There are potential advantages and disadvantages to using Ordinary Level-Premium Whole Life Insurance.
Advantages
- There is a fixed annual premium
- The cash surrender value
- Guaranteed mortality and expense risk ceiling (fee charged based on the risk of insuring an individual)
- Guaranteed minimum interest rate credited to the cash value
- Cash value earnings accumulate tax-free or tax-deferred depending on distribution at death
- Cash values can be borrowed at generally low net costs
- The policies can typically be used as collateral for personal loans
- Life insurance proceeds are typically paid directly to the beneficiary and not subject to probate

Disadvantages
- Distributions of cash values are subject to income tax for the attributable gain on the policy
- Premiums may be unaffordable
- Interest paid on policy loans is not tax-deductible
- The overall rate of return on the cash value inside a policy has generally not been historically competitive with alternative investments
- Surrender of the policy within the first five to ten years may result in a considerable loss, since surrender values reflect the company’s recovery of sales commission and initial policy expenses

Universal Life Insurance
Universal Life (UL) Insurance is a flexible premium, current assumption, adjustable death-benefit, cash value life insurance policy. Flexible premiums allow the insured to select, adjust, and change the premium. Current assumption means that current interest rates and mortality and expense charges are used to determine how much of the premium goes to the cash value. An adjustable death benefit allows the insured to raise or lower their death benefit; however, increasing the benefit may require evidence of insurability. This type of policy would generally be well suited for the following situations:

Advantages
- When flexibility is desired and the need for insurance coverage is expected to change.
- For young families who may want to adjust their premiums and benefit as they start having children, make more money, or incur expenses such as college costs.

Disadvantages
- The fl exibility associated with UL can cause policies to lapse if not properly monitored and maintained
- Mortality and expense charges are only guaranteed not to exceed certain maximums; therefore the risk of changing mortality trends is taken by the insured. The result may be higher expenses during adverse trends, with the possibility of lower expenses during improving mortality trends
- Surrender of the policy in the first five to ten years may result in a considerable loss since the surrender values represent the insurance company’s recovery of sales commissions and initial policy expenses
The flexibility of the premium payments may allow the policy to inadvertently become a modified endowment contract (MEC).

A MEC is a life insurance policy that is funded in a certain way. If a life insurance policy or annuity does not pass the seven-pay test (premium payments are too high and the policy becomes paid up in less than the first seven years) it becomes a MEC, under which withdrawals may be taxed as ordinary income and subject to a 10% penalty for withdrawals from the policy before age 59 ½.

**Variable Life & Variable Universal Life Insurance**

Variable Life (VL) Insurance combines traditional whole life insurance with mutual fund-like investments. Within this policy, the insured has the ability to direct the investments of the cash value. If the investments chosen increase in value so does the death benefit, and if the investments chosen perform poorly, the death benefit may decrease, but not below a guaranteed minimum stated in the policy. There are primarily two ways to calculate the benefit for a VL policy, the corridor method (uses an adjusted percentage of the cash value to determine the death benefit) and the net single premium approach (uses the cash value to estimate the amount of insurance that could be purchased with a single payment policy). VL Insurance has most of the features of traditional level-premium life insurance, as well as offering various riders and premium payment plans.

Variable Universal Life (VUL) Insurance is a combination of Universal Life Insurance and Variable Life Insurance. Under this policy, the insured can typically determine the amount and frequency of payments, skip payments if the cash value will cover the mortality and expense charges, make adjustments to the amount of coverage based on inflation or changing needs, and withdraw money without creating a loan if the remaining cash value can cover the mortality and expense charges. Therefore, the major difference between VL policies and VUL policies is that with VUL policies, the insured has the same control over the premiums and premium payments as they would with a Universal Life Insurance policy.

VL policies are classified as securities and as such, buyers must be given a prospectus. Variable products generally suit the needs of persons who want to maintain control over their cash values and may need increasing life insurance protection. The purchaser of these policies should understand investments and their risks.

**Advantages**

- Policy owners have control over how premiums and cash flows are invested
- Tax-free switches between investment options are usually allowed at least once a year
- Cash values in variable policies are based on the market value of the assets and are readily available in the event of insolvency on the part of the insurer
- Earnings on the underlying assets in the policy accumulate tax-free or tax-deferred depending on when gains are distributed
- There are cost-of-living riders available that allow increases in the policy death benefit
- Life insurance proceeds are typically paid directly to the beneficiary and not subject to probate

**Disadvantages**

- The policy owner bears all of the investment risk
- The VL death benefits depend upon the investment performance of the assets underlying the policy
- If the investment performance of a VUL is poor, additional premiums may be due to maintain the face amount of the policy
- Lifetime withdrawals and distributions are subject to income tax to the extent they are attributable to gains in the policy
- Flexibility with respect to premium payments may result in a change in the policy which results in it becoming a modified endowment contract (MEC)
- Expenses are generally greater than other types of policies
Survivorship Life Insurance
Survivorship Life Insurance, also called second-to-die, is a type of policy that operates as joint insurance. The policy usually covers two lives (some companies offer three or more) and premium payments continue until both parties die, upon which the proceeds go to the beneficiaries. Survivorship Life Insurance policies can provide estate liquidity at the second death of a married couple. These types of policies can also protect two career families and help fund charitable bequests.

Advantages
- Premiums are lower than for equivalent insurance in two separate policies
- Medical underwriting standards are often eased since benefits are not paid until the last death
- There are alternative term/permanent life combinations available that provide flexibility in premium payments and death benefits

Disadvantages
- Survivorship Life Insurance provides no benefit at the first death without a specified rider
- There is a risk that premiums could escalate prohibitively if dividends are lower than projected for Permanent Life Insurance policies and/or rates increase for Term Insurance policies

Special Provisions & Riders
There are many additional provisions that may be added to a life insurance contract that potentially allow flexibility and enhance the policy to fit the needs of the insured.

Accelerated-death-benefit riders
These are newer types of riders that allow the insured to receive up to the entire face amount of the policy before death if they become diagnosed with a terminal disease or encounter circumstances which will significantly affect their longevity and quality of life (i.e., organ transplants, entering a nursing home). The share of the face value paid out generally ranges from 25%-100% depending on the reason for the payout. Nursing home care may pay 70%-85%, while a terminal disease may pay 90%-98%.

Accidental-death-benefit riders
Accidental-death-benefit riders allow the policy to pay some multiple (usually double) of the base policy in the case of an accidental death. There are two clauses for this rider: “accidental” which states that if the death was accidental (e.g., intended to go downstairs and fell) the policy will pay the extra benefit. The other clause, “accidental means,” states that both the death and the cause of the death have to be accidental (e.g., a person falling down stairs because they tripped on their child’s roller skate) in order for the extra benefit to be paid. In circumstances where the “accidental means” clause is used, it is generally difficult to determine when the benefit will or will not be paid.

Additional purchase options
Additional purchase options are attached to permanent policies on younger insureds. These options allow younger people who cannot afford a large initial face value to add additional coverage to their policy without evidence of insurability at specific times or certain life events. The ability to add options usually occurs every three years from age 25 to 40 and requires a minimum addition, typically $5,000 or $10,000 of additional coverage.

Automatic premium loan provision
When a premium goes unpaid and the grace period lapses, the automatic premium loan provision will allow the necessary premium payment to be taken from the cash value as long as its value is sufficient to cover the premium.

Bailout provisions
Most current-assumption and universal policies use surrender charges instead of front-end loads to recover issuing expenses. However, a bailout provision allows for the surrender charges to be waived if the rate of return on the policy’s cash value falls below a minimum level.

Common accident provision (survivorship clause)
This provision allows for the beneficiary to avoid having the insurance benefits included in their estate if they die within a certain time period of the insured, usually seven to thirty days. If the beneficiary does not survive the designated time period, the contingent beneficiary will be paid the benefit.
**Cost-of-living riders**
Cost-of-living riders are typically used with Term Insurance policies and will increase the benefit based on the increase in cost-of-living.

**Disability income riders**
Similarly to waiver-of-premium riders, a disability income rider will allow the disabled person to have premiums waived and receive additional income from their policy if they meet the insurer’s definition of total disability. Different insurers will use different definitions to determine if the insured is totally disabled, but the general definition is that the insured is unable to perform their own job for two years and may not perform a job for which they are reasonably suited by education, training, and experience. There is usually a six month waiting period associated with this rider and premiums will generally be more expensive the looser the definition of total disability.

**Limitation riders**
Limitation riders may be added by the insurance company to reduce their liability.

- War riders prevent insurance from being paid due to a death by war acts and have been expanded to police actions as well
- Aviation riders prevent insurance from being paid due to a plane crash unless death occurs during a scheduled commercial flight
- Hazardous occupations riders will prevent insurance from being paid to a person who has a hazardous occupation (i.e., lumberjack, skyscraper window cleaner, etc.) if death occurs as result of the occupation
- Limited-benefit-period riders are typically used for people with pre-existing health conditions who otherwise might be uninsurable and gradually increase the insurance benefit over the lifetime of the insured

**Term riders**
Term riders allow the insured to add additional coverage to a permanent policy through a term contract when there may be a temporary need that is more than the existing long-term coverage.

**Waiver-of-premium riders**
This rider is a form of disability insurance, which allows the current policy to remain in force if the insured becomes disabled and is incapable of paying the premiums. There are different periods of coverage and waiting periods associated with this type of rider. In most cases, the period of coverage will last until the policy would have terminated or endowed if a person became disabled before age 60. If the insured becomes disabled after age 60, most periods of coverage will last until the disabled reaches age 65, although some policies allow for a longer period. Most waiting periods will last six months in order to qualify for a disability waiver of premium.

**Tax Benefits**
A very important aspect of life insurance planning is the tax treatment of these policies and their features. While the information below provides general information on the tax treatment for insurance policies, a qualified tax professional should be consulted to determine how a given policy may impact a given individual’s tax situation.

**Income Tax**
The benefits of a life insurance policy are affected by income tax in two ways: benefits during the insured’s lifetime, and benefits at the insured’s death.

The tax treatment during the insured’s life:

- The year by year increase in the cash value of the policy will generally not be subject to income taxes
- Dividends are typically considered returns of premiums paid and are usually tax-free, unless they exceed the amount of premiums paid
- Policy withdrawals made from the cash value that do not exceed the premiums paid are generally not considered taxable income

The tax treatment during the insured’s death:

- The benefits of a life insurance policy at the death of the insured are generally income tax exempt
- The proceeds are tax-free whether paid in installments or a lump-sum
- However, if the benefits are paid at a date later than death or in installments, interest earned on the benefits is taxable
Gift Tax
There are certain tax benefits related to gifting policies. Gifts of life insurance are favorable for the following reasons:

- Unlike a gift of property, which leaves the individual without the after-tax income he/she would have received from selling the property, an insurance policy gift will usually have the premiums paid for by the donee allowing excess income to the donor which otherwise would have been spent on the policy premiums.

- There is no realized gain for income tax purposes when the policy matures, even if the policy was a gift, unlike other types of property gifts which incur taxes based on the realized gain upon the sale of the gifted property.

Estate Tax
There are situations where life insurance proceeds will be included in one’s estate. In some cases the policy’s lifetime value will be included and in others the policy proceeds will be included.

- If a policy is owned by a descendant of the insured and the descendant predeceases the insured, the cash value of the life insurance will be included in the descendant’s estate.

- If the policy was transferred but the insured maintained the right to enjoy the legal rights of the policy, have the policy revert back to them or their estate, alter, amend, or terminate the policy, the insured has held an “incident of ownership” and the proceeds will be considered part of the insured’s estate if the incident occurred within three years of death.

- If the policy proceeds were paid to the insured’s estate, the proceeds will be considered part of the insured’s estate.

Just as there are different circumstances for which life insurance proceeds can be included in one’s estate, there are several ways to remove the proceeds from an estate and reduce the potential estate taxes. One of the most common ways is to establish an Irrevocable Life Insurance Trust (ILIT). An ILIT is an irrevocable trust created for the principal purpose of owning a life insurance policy. As with any other trust, the insurance trust is a contract between a grantor and a trustee to administer certain property, in this case an insurance contract, for the benefit of named beneficiaries. The insurance trust, like other irrevocable trusts, cannot be rescinded, amended, or modified in any way after it is created. If an ILIT is properly structured, the death benefits paid to the trust will be free from inclusion in the gross estate of the insured. In addition, the ILIT can also be structured so that the trust will provide benefits to the insured’s surviving spouse without inclusion in the surviving spouse’s gross estate either.

Conclusion
Insurance is not a panacea that solves all problems, but the numerous available policy types, features, and riders provide flexibility to address many unique situations. Every individual will have their own set of goals and priorities and by accurately calculating these needs and deciding which policy best suits them, one can help make sure those needs are met. A financial planner or insurance expert should be able to guide someone considering a life insurance policy through the process of deciding how much insurance and what type of policy they will want based on the their family’s needs. In addition, due to the complex tax treatment of insurance policies and their use in estate planning, qualified tax and legal professionals should also be consulted to ensure that the selected policies are consistent with the individual’s overall financial goals.

Approved SMA-CAG-WP022 (11/15)