



## Chapter 8

### Life Insurance Premiums & Proceeds

#### Primary Premium Factors – M.I.X.

- **Mortality** – Table tells probability of death & Life expectancy
- **Interest** – Generally the higher the interest the company assumes it can earn, the lower the premium; vice versa
- **Xpense** – “loading charge”

**Rating** – adjusting the premium upward to account for sub-standard risks

#### Methods of Rating

1. **Extra Per centage** method – charging 125 – 500% more. Most common
2. **Permanent Flat Extra Premium** – adding an additional flat dollar amount per thousand. Insured may apply to have it removed if condition changes. Extra charge does not add to cash values.
3. **Temporary Flat Extra Premium** – same as above but a temporary rating

**Level Premium Funding** – a method of keeping the premiums level over a long period of time. Insured pays more in the early years than the true mortality cost and less in the later years than the true mortality cost.

#### Reserves –

- The amount of money the insurance company must set aside to guarantee payment for future claims.
- Each state mandates a certain reserve requirement
- Reserves are a liability to the insurance company, not an asset.

#### Cash Value

- The amount of money in a permanent policy (whole life, universal life, etc.) belonging to the policy owner
- An asset to the policy owner
- Earns interest;
- interest not taxed while accumulating;

#### Premium Modes

- Annually, semi-annual, quarterly, monthly
- Extra charge if paying more frequently than annual
- All premiums are deemed to be paid in advance

**Taxation of Premiums** – only deductible under the following circumstances

- **Business Creditors**
- **Charitable Organizations** - policy owned by a charity
- **Group Life**

**Tax Treatment of Cash Values**

- Earns interest and this interest is not taxed while it is inside the policy
- May be borrowed against (Loans)
- Loans are not taxed
- If policy is surrendered (cash-in), the amount above the cost basis (your gain) is taxed as ordinary income (ordinary income means you add your gain to whatever income you made for the year)
- Cost is determined by:
  - total premiums paid, minus policy dividends, equals your cost

**Life Insurance Proceeds**

- Death benefit is tax free; if interest is paid on proceeds, the interest IS taxable
- Free from insured's creditors

**Settlement Options**

1. **Lump sum**
2. **Interest only** – company holds the death benefit and pays the beneficiary interest payments (taxable). {pays a guaranteed rate but may be higher, never lower}
3. **Fixed-Period Option** – company pays both principle & interest over a fixed period of time, at a guaranteed interest rate. If interest rate goes up, payment increases, not the time period. The part of the payment representing interest IS taxable.
4. **Fixed-Amount Option** - company pays a fixed dollar amount (principal & interest) at a guaranteed interest rate. If interest rate goes up, the time period lengthens, not the dollar amount. The part of the payment representing interest IS taxable.
5. **Life Income** – Company pays the principal & interest for as long as the beneficiary lives (an annuity). Company uses a mortality table to find the life expectancy and uses that as to how long they will pay. If the beneficiary continues to live beyond that, they still get paid. Again, the interest IS taxable.

**Living Benefits**

**Accelerated Benefits**

- Must be terminally or chronically ill
- Policy pays a large percentage of the proceeds to insured if:
  - a. **Terminally Ill**
    - Dr. certifies that death will occur within two years (terminal)
    - Benefits are tax free
  - b. **Chronically Ill**
    - Certified as unable to perform at least two Activities of Daily Living
    - Requires substantial supervision to protect insured from self-harm
    - Some of the benefit is tax free; IRS limits the amount

### **Viatical Settlements**

- Terminally or Chronically Ill policy owner
- Policyowner sells their policy to a viatical company
- Viatical company owns the policy
- No taxes to the policy owner
- Viatical company WILL owe taxes on the gain
- Viatical companies must be a licensed insurance agent

### **Life Settlements**

- Same as a viatical but insured is not terminally or chronically ill
- Could be taxable (insured not terminal)

### **Tax Treatment of Proceeds**

#### **Transfer for Value Rule**

- The transfer-for-value rule stipulates that if a life insurance policy is transferred (sold) for something of value (e.g., money, property, etc.), a portion of the death benefit is subject to taxation as ordinary income.
- This why viaticals are taxed
- Exceptions (not taxed):
  - Policyowner transfers policy to insured
  - Policyowner transfers policy to a partnership or corporation of the insured

#### **Proceeds paid during Insured's Lifetime**

- Loans – not taxed
- Surrender – gain is taxed (ordinary income)
- Endowment policies endowing before age 95
- Viaticals – (Insured – Tax Free); (Viatical Co. – Taxed on gain)
- Accelerated Benefits
  - Terminally ill – not taxed
  - Chronically ill – money over a certain amount IS taxed
- Withdrawals (universal life) – Gains taxed – F.I.F.O method
- Withdrawals (annuities) – Gains Taxed – L.I.F.O. method

#### **1035 Exchanges – Tax code** Allowing for tax free roll-over to similar “like kind products.

- Life policies to life policies
- Life policy to annuity
- Annuity to annuity
- **NOT** annuity to life policy