PRINCIPLES OF RISK MANAGEMENT AND INSURANCE

CLASS NOTES

Chapter 18 Buying Life Insurance

Topics

- Determining the Cost of Life Insurance
- Rate of Return on Saving Component
- Taxation of Life Insurance
- Shopping for Life Insurance

Determining the Cost of Life Insurance

- The cost of a life insurance policy is the difference between what you pay and what you get back
- When determining the cost of life insurance, four major factors must be considered:
  1. Annual premiums
  2. Cash values
  3. Dividends
  4. Time value of money
- Under the traditional net cost method, the cash value and expected dividends are subtracted from annual premiums to obtain a net cost per year figure
  – This method does not consider the time value of money
- The interest-adjusted cost method is more accurate because it considers the time value of money
- Interest-adjusted cost indices come in two forms:
  – The surrender cost index is useful if the owner expects to surrender the policy after some time period
  – The net payment cost index is useful if the owner expects to keep the policy in force
- Interest-adjusted cost indices can be used to compare policies across insurers
  – There is a wide variation in costs indices across insurers – it pays to shop around!
  – Most consumers use premiums as a basis for comparison, but agents will supply cost indices
- The Life Insurance Policy Illustration Model Act requires insurers to present certain information to applicants for life insurance
  – The goal is to reduce misunderstanding of policy values by policyowners, and reduce deceptive sales practices by agents
  – A narrative summary describes the basic characteristics of the policy
  – A numeric summary shows the premium outlay, value of the accumulation account, cash surrender values and death benefit
  – The act also prohibits certain sales practices and requires the insurer to provide an annual report

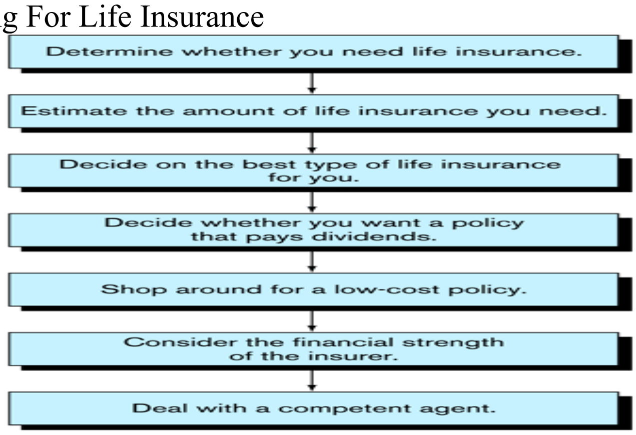
Rate of Return on Saving Component

- The annual rate of return earned on the savings component of a policy is an important consideration if you intend to invest over a long period of time
- The Linton yield is the average annual rate of return on a cash value policy if it is held for a specified number of years
  - Current information is not readily available to consumers, so the method has limited use

Taxation of Life Insurance

- Life insurance proceeds paid in a lump sum to a designated beneficiary are generally received income-tax free
  - The interest component of periodic payments is taxable as ordinary income
  - Premiums are generally not deductible
  - Dividends are not taxable, but interest on dividends retained is taxable
  - If a policy is surrendered for its cash value, any gain is taxable as ordinary income
- Proceeds from a life insurance policy are included in the gross estate of the insured for federal estate-tax purposes if:
  - the insured has any ownership interest
  - they are payable to the estate
- The proceeds may be removed from the gross estate if the policyowner makes an absolute assignment of the policy to someone else
  - The policyowner must make the assignment more than three years before death
- A federal estate tax is payable if the decedent's taxable estate exceeds certain limits
  - A tentative tax on the taxable estate value is calculated
    - The gross estate includes property you own, one-half of the value of property owned jointly with your spouse, life insurance death proceeds in which you have ownership interest
    - The gross estate may be reduced by certain deductions, such as a marital deduction, in determining the taxable estate
    - The taxable estate may be reduced or eliminated by a tax credit called a unified credit
  - The amount of property exempt from taxation will increase in the future
  - Federal estate taxes are scheduled to expire in 2010
    - Tax will be reinstated in 2011 unless Congress acts

Shopping For Life Insurance



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