

Class 7 Outline
Business Finance 640
Autumn Quarter, 2007

This class will complete our discussion of contractual provisions of life insurance contracts, which was begun in the previous class.

We will start by reviewing dividend options, non-forfeiture options and settlement options. We will then discuss additional life insurance benefits that can be added to a policy. These include waiver-of-premium, guaranteed purchase option, accidental death benefit rider, cost of living rider, accelerated death benefits rider, viatical settlements and life settlements.

From this, we will transition to a brief discussion of the taxation of life insurance. In this context, we will look at both federal income tax and federal estate tax implications for life insurance. We will conclude by discussing how life insurance premiums are calculated. We will review both the net single premium method and the net annual level premium method

I. Dividend Options

A) Sources of Surplus for Dividends

1. Higher interest earnings than assumed
2. Lower mortality than expected
3. Lower operating expenses than expected

B) Ways of Taking Dividends

1. Cash
2. Reduction of premiums—the dividend is used to reduce the next premium coming due.
3. Accumulate at interest—company guarantees a minimum rate on dividend accumulations but may pay a higher rate depending on market conditions.
4. Paid-up additions—the dividend can be used as a single premium to buy additional amounts of paid-up insurance.
5. Term insurance—in some policies, the dividend can be used to purchase term insurance.

C) Other Uses of Dividends

1. Can convert the policy into a paid-up contract
2. Can mature the policy as an endowment

II. Nonforfeiture Options

A) Cash Value

1. Surrender of the policy for its cash value
2. Little or no cash value during the early years
3. Payment of cash value can be delayed for six months if policy is surrendered (seldom used).

B) Reduced Paid-up Insurance

1. Cash value is used to buy a reduced paid-up policy
2. Appropriate option for someone with limited income who still has some life insurance needs

C) Extended Term Insurance—cash value is used to extend the full face amount of insurance into the future as term insurance for a certain number of years and days.

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III. Settlement Options

- A) Cash—most proceeds are paid as cash.
- B) Interest Option
 - 1. Interest paid to the beneficiary
 - 2. Minimum interest rate guaranteed
 - 3. Beneficiary can make withdrawals.
 - 4. Advantages: flexibility, may allow a change to another option, can be used in a variety of circumstances
 - 5. Main disadvantage: other investments may yield higher return.
- C) Fixed Period Option
 - 1. Pays monthly, quarterly, semiannual, or annual payments
 - 2. Death of beneficiary—remaining payments go to a contingent beneficiary or to the estate of primary beneficiary if the beneficiary dies before receiving all payments
 - 3. Uses—where income is needed for a definite period of time, such as the Social Security “black-out” period; readjustment period; family dependency period
 - 4. Limitations—inflexible since partial withdrawals are not allowed
- D) Fixed Amount Option
 - 1. Specified amount paid to beneficiary each time period
 - 2. Advantages: considerable flexibility on withdrawals; may be allowed to change to another option or increase and decrease the fixed amount
- E) Life Income Options
 - 1. Life income only
 - 2. Life income with a period certain
 - 3. Life income with refund option
 - 4. Joint-and-survivor life income option
- F) Advantages of Settlement Options
 - 1. Periodic income to the family
 - 2. Guaranteed principal and interest
 - 3. Can be useful in life insurance planning
 - 4. Long-term guarantees
 - 5. No additional cost
- G) Disadvantages of Settlement Options
 - 1. Higher yields elsewhere
 - 2. Settlement agreement may be inflexible and restrictive.
 - 3. Life income options not attractive at younger ages
 - 4. Insurance windfall can create problems for the beneficiary.
- H) Use of a Trust
 - 1. Desirable when the amount of insurance is substantial and judgment in making payouts is required
 - 2. Limitations: expense involved; no guarantee of investment results

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IV. Additional Life Insurance Benefits

- A) Waiver-of-Premium
- B) Guaranteed Purchase Option
- C) Double Indemnity Rider
- D) Cost-of-Living Rider
- E) Accelerated Death Benefits Rider

V. Taxation of Life Insurance

- A) Federal Income Tax
- B) Federal Estate Tax

VI. Calculation of Life Insurance Premiums

- A) Net Single Premium
- B) Net Annual Level Premium