

Insurance Planning Handout

Match the following special legal characteristics of an insurance contract with its correct description.

- | | | |
|-----------------------------|------------------------------|-----------------------|
| 1. Actual Cash Value | 5. Indemnity | 8. Subrogation |
| 2. Adhesion | 6. Insurable Interest | 9. Unilateral |
| 3. Aleatory | 7. Misrepresentation | 10. Warranty |
| 4. Concealment | | |

1. _____ The insured should not profit from insurance as its purpose is to put the insured in the same financial position as before the loss occurred.
2. _____ Requires that only an individual who will incur a financial loss can insure property. For life insurance only needed at the time of application.
3. _____ Limits the amount of reimbursement on a property insurance contract to replacement cost reduced by an allowance for depreciation.
4. _____ Principle in property and liability insurance that gives the insurer the legal rights of the insured against a third party for amounts paid insured.
5. _____ Insurance contracts are one party contracts as only the insurer is legally bound to do anything. The insured makes no legally enforceable promises.
6. _____ The contract is drawn up entirely by the insurer. This results in ambiguous language generally being interpreted in favor of the insured.
7. _____ The contract's benefits are completely determined by chance. It almost always will result in unequal dollars given up between the parties.
8. _____ A misstatement of facts by an insured at time of application that if material enough may provide a basis for the insurer to void the policy.
9. _____ A written statement made by the insured which if breached can void the policy regardless of materiality. For example, a written promise to keep fire alarms in working order.
10. _____ Failure of applicant to willfully disclose material facts that the insurer could not be expected to know. This is a disclosure omission whereas misrepresentation is a misstatement of disclosed facts.

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1. 5: The insured should not profit from insurance as its purpose is to put the insured in the same financial position as before the loss occurred.
2. 6: Requires that only an individual who will incur a financial loss can insure property. For life insurance only needed at the time of application.
3. 1: Limits the amount of reimbursement on a property insurance contract to replacement cost reduced by an allowance for depreciation.
4. 8: Principle in property and liability insurance that gives the insurer the legal rights of the insured against a third party for amounts paid insured.
5. 9: Insurance contracts are one party contracts as only the insurer is legally bound to do anything. The insured makes no legally enforceable promises.
6. 2: The contract is drawn up entirely by the insurer. This results in ambiguous language generally being interpreted in favor of the insured.
7. 3: The contract's benefits are completely determined by chance. It almost always will result in unequal dollars given up between the parties.
8. 7: A misstatement of facts by an insured at time of application that if material enough may provide a basis for the insurer to void the policy.
9. 10: A written statement made by the insured which if breached can void the policy regardless of materiality. For example, a written promise to keep fire alarms in working order.
10. 4: Failure of applicant to willfully disclose material facts that the insurer could not be expected to know. This is a disclosure omission whereas misrepresentation is a misstatement of disclosed facts.

Insurance Planning Handout

A. Entire Contract Clause

The **POLICY** and the attached application constitute the entire contract between the insurer and the insured. Thus, in a court dispute parole (oral) evidence may not be introduced to show different terms than what is written.

B. Incontestable Clause

The incontestable clause is a mandatory provision that states that the validity of a life insurance contract cannot be questioned once the policy has been in effect for at least **2** years. Even **FRAUD** generally cannot be used to rescind the contract except in a few very limited cases.

C. Misstatement of Age

A misstatement of age provides that if insured has misstated his or her age, the policy **FACE** amount will be adjusted to the amount of insurance that the premium would have purchased using the correct age. The **INCONTESTABLE** clause does not apply when the insured misstates his or her age.

D. Grace Period

A grace period is a period of time (generally **31** days) allowed for the late **PAYMENT** of a premium before a policy is allowed to lapse. If the insured dies after the premium due date, but before the grace period expires the proceeds will be **REDUCED** by the premiums in default.

E. Reinstatement Clause

A reinstatement clause allows the insured to **REINSTATE** a lapsed policy within a specified period (generally five years) after premium default if the policy has not been surrendered for its cash value. It requires evidence of **INSURABILITY** and the payment of all overdue premiums with interest.

F. Suicide Clause

A suicide clause is a provision that limits the insurer's liability to a return of **PREMIUMS** if the insured commits suicide within the first **2** years of the policy's inception. To use this clause, the insurance company must prove conclusively that the death was a suicide.

G. Ownership Provision – insurance for Estate Tax purposes

The owner of a life insurance contract has the right to assign or transfer the policy, the right to receive **DIVIDENDS** and cash values, and the right to borrow against the policy. The applicant, the insured, and the owner can all be different individuals.

H. Assignment Provision

This is a provision that describes how the ownership of a life insurance policy may be transferred. An absolute assignment is **IRREVOCABLE** whereas a **COLLATERAL ASSIGNMENT** is temporary with the possibility of rights returning to the assignor if agreed upon conditions occur.

I. Loan Provision

This type of provision permits the insured to **BORROW** from the insurance company an amount equal to the cash surrender value of a policy. There is no legal obligation to **REPAY** the loan and if the insured dies it will be deducted from the policy's proceeds. Most policies contain an automatic loan provision for the payment of late premiums.

J. Exotic Questions

1. **T** F Life insurance policies can be backdated for up to six months to take advantage of lower rates at a younger age.
2. **T** **F** Ownership of life insurance policies can only be transferred to someone with an insurable interest.

Insurance Planning Handout

Stop-loss Limit or Breakpoint

Represents the dollar amount at which the **INSURED** no longer is required to pay under a Coinsurance provision. After it has been reached, the **INSURER** pays all of the insured's medical costs.

a. Example:

"X" has a health insurance policy containing an 80-20 coinsurance provision after applying a \$1,500 deductible. The plan also has a \$10,000 cap including the deductible. Compute the amount the insurer would pay in each of the following cases:

	<u>Expenses</u>	<u>Insurer</u>	<u>Insured</u>
Case 1	\$ 9,500	\$ _____	\$ _____
Case 2	2,250	_____	_____
Case 3	15,250	_____	_____
Case 4	18,250	_____	_____

"X"'s Claims in 1 year	Claim Amounts	Deductibles		Co-Insurance		Stop-Loss Limit \$10,000		Total	
		Insurer	Insured	Insurer 80%	Insured 20%	Insurer	Cum. Insured	Insurer	Insured
Claim 1	9,500								
Claim 2	2,250								
Claim 3	15,250								
Claim 4	18,250								
Totals	45,250								

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a. Example:

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	<u>Expenses</u>	<u>Insurer</u>	<u>Insured</u>
Case 1	<u>\$ 9,500</u>	<u>\$ 6,400</u>	<u>\$ 3,100</u>
Case 2	<u>2,250</u>	<u>1,800</u>	<u>450</u>
Case 3	<u>15,250</u>	<u>12,200</u>	<u>3,050</u>
Case 4	<u>18,250</u>	<u>14,850</u>	<u>3,400</u>

"X"'s Claims in 1 year	Claim Amounts	Deductibles		Co-Insurance		Stop-Loss Limit \$10,000		Total	
		Insurer	Insured	Insurer 80%	Insured 20%	Insurer	Cum. Insured	Insurer	Insured
Claim 1	9,500	0	1,500	.80 X 8,000 = 6,400	.20 X 8,000 = 1,600	0	3,100	6,400	3,100
Claim 2	2,250	0	0	.80 X 2,250 = 1,800	.20 X 2,250 = 450	0	3,550	1,800	450
Claim 3	15,250	0	0	.80 X 15,250 = 12,200	.20 X 15,250 = 3,050	0	6,600	12,200	3,050
Claim 4	18,250	0	0	.80 X 18,250 = 14,600	.20 X 18,250 = 3,650; limited to 3,400	3,650 - 3,400= 250	Max 10,000	14,600 + 250 = 14,850	3,400
Totals	45,250			35,000	8,500	250	10,000	35,250	10,000

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Commercial Property Insurance

This is a policy provision on commercial business property that requires the insured to maintain insurance equal to a minimum percentage of the building's replacement value (generally **80** percent). If less insurance is carried, recoveries under the policy are **REDUCED** on a proportional basis.

1. Identify the formula used by the insurer to compute its required payment.

$$\left(\frac{\text{Coverage}}{\text{Insurance Required}} \times \text{Loss} \right) - \text{Deductible} = \text{Reimbursement}$$

NOTE: The reimbursement is the **GREATER** of this amount or the actual cash value of the damaged part of the building.

2. Example:

Two years ago the insured purchased a building for \$900,000 that has a current FMV of \$1,200,000 and a replacement cost of \$1,000,000. Currently, the insured has an \$600,000 policy with an 80% coinsurance provision and a \$500 deductible. Compute the insurance reimbursement on a \$500,000 loss.

Step # 1: Required Coverage:

Step # 2: Reimbursement:

Solutions:

Step # 1: Required Coverage: **\$1,000,000 X 80% = \$800,000**

Step # 2: Reimbursement: **(\$600,000 / \$800,000) X \$500,000 = \$375,000 – 500 = \$374,500**

What if the damaged part was:

ACV \$400,000
 Insurance Co. \$400,000

Cost – A / D ≠ Loss = FMV Replacement Costs

Insurance Planning Handout

A. Identify the types of perils covered by basic and broad form coverage.

1. **BASIC:** Includes the following twelve (12) perils:

- | | |
|----------------------------|-----------------------|
| 1. Fire | 7. Vehicles |
| 2. Windstorm | 8. Aircraft |
| 3. Hail | 9. Smoke |
| 4. Lightening | 10. Vandalism |
| 5. Explosions | 11. Theft |
| 6. Riot or civil commotion | 12. Volcanic eruption |

*HO 00 01: A policy providing **BASIC** coverage on both **DWELLING** and **CONTENTS**. It is rarely used in practice.*

2. **BROAD FORM:** Includes perils covered under “basic” plus the following (7):
(Broad form covers 19 items)

- | | |
|----------------------------------|---|
| 1. Falling objects | 5. Artificial electrical current damage |
| 2. Weight of ice, snow, or sleet | 6. Explosion of steam or hot water system |
| 3. Water overflow W / D | 7. Building collapse |
| 4. Freezing | |

*HO 00 02: A basic policy providing **BROAD** form coverage on both dwelling and contents. Has been replaced by HO 00 **03** as the most common policy.*

B. **OPEN PERIL FORM:**

Includes coverage for **ALL** perils unless specifically excluded in the homeowner's policy.

*HO 00 03: Similar to HO 00 02 except it provides **OPEN** peril coverage on the dwelling. An HO 00 **15** rider expands the open-peril coverage to the dwelling's contents.*

*HO 00 05: Combines the HO 00 **03** form with the HO 00 **15** rider to provide open perils coverage on both the dwelling and personal property in one policy.*

C. List the general “**EXCLUSIONS**” that apply to all of the homeowners forms.

- | | |
|---------------------------|---------------------------------------|
| 1. Ordinance or law | 5. Neglect or failure to try and save |
| 2. Earth movement | 6. War |
| 3. and other water damage | 7. Nuclear hazard |
| 4. Power failure | 8. Intentional loss |

D. List the most common “**EXCLUSIONS**” for personal property.

- | | |
|-----------------------------|--|
| 1. Items insured elsewhere | 5. Property in a rental apartment |
| 2. Animals, birds, or fish | 6. Property rented to others |
| 3. Business inventory | 7. Automobiles and other motorized land vehicles |
| 4. Aircraft and their parts | 8. Credit cards |

Insurance Planning Handout

You need to know the numbers of these policies:

- HO 00 01: A policy providing **BASIC** coverage on both **DWELLING** and **CONTENTS**. It is rarely used in practice.
- HO 00 02: A basic policy providing **BROAD** form coverage on both dwelling and contents. Has been replaced by HO 00 **03** as the most common policy.
- HO 00 **03**: Similar to HO 00 02 except it provides **OPEN** peril coverage on the dwelling. An HO 00 **15** rider expands the open-peril coverage to the dwelling's contents.
- HO 00 04: Generally used by **RENTERS** either in a rented dwelling or an apartment. Purpose is to provide coverage for personal property such as furniture and clothes.
- HO 00 **05**: Combines the HO 00 **03** form with the HO 00 **15** rider to provide open perils coverage on both the dwelling and personal property in one policy.
- HO 00 06: Designed to be used by **CONDOMINIUM** owners. The condo association is generally responsible for insuring the common areas and the building exterior.
- HO 00 **08**: A basic homeowner's policy that settles loss on an **ACV** basis. Intended for "older" structures where the cost to replace far exceeds the value of the structure.

NOTE: Policies are designed for owner-occupants of buildings used for private residential purposes by not more than **2** families. Incidental office or studio occupancies are permitted.

A. Section 1: Property Losses – represents dollars paid to Insured:

1. Coverage A- Dwelling & Attached

This covers the dwelling and any structures attached to the dwelling such as an attached garage. It does not cover **LAND**, but does cover construction supplies if they are being used to work on the "insured" dwelling.

2. Coverage B- Other Structures

This covers structures detached from the dwelling for an amount up to **10** percent of the dwelling coverage. Examples include detached garages, sheds with a foundation, fences, patios, and swimming pools.

3. Coverage C- Personal Property

This covers all personal property owned or used by the insured anywhere in the **WORLD** except for certain exclusions as shown on the next page. Generally, equals **50** percent of the dwelling coverage but without an endorsement, reimbursement is limited to actual cash value.

NOTE: The following items generally have specific dollar **LIMITATIONS**: cash \$200; jewelry, furs, watches, watercraft, securities, collectibles, and electronic equipment \$1,000; firearms \$2,000; silverware and business property \$2,500.

4. Coverage D- Loss of Use

This covers additional **LIVING** expenses when premises are rendered uninhabitable by the insured. Examples include: hotel, motel, furniture rental, extra miles to work, incremental costs of dining-out, and any other additional costs not normally incurred.

Insurance Planning Handout

Section 2: Liability Losses – represents dollars paid to others.

1. Coverage **E**- Personal Liability

Personal liability provides liability coverage for bodily injury and property damage caused by the insured and his or her family members to **OTHERS**. Generally has **\$100,000** limit per occurrence but legal fees and court costs will be paid in addition to this amount.

NOTE: Liability coverage excludes claims arising from watercraft, aircraft, autos, business activities, contracts, intentional injuries, and communicable diseases.

2. Coverage **F**- Medical Payments – applies to moral obligation

This provision covers the medical expenses of anyone (other than the insured and family members) injured on the insured's **PREMISES** regardless of fault. Also, includes any injury resulting from an activity of the insured and his or her family members (including pets) regardless of where it occurred. Generally limited to **\$1,000** per person per occurrence.

NOTE: Coverage E and F are **IDENTICAL** in all HO forms. Also, family members include "resident" relatives and anyone under age **21** living in the insured's household.

3. Complete the following chart regarding homeowner's coverage.

<u>Policy</u>	<u>Coverage A</u> <u>Dwelling</u>	<u>Coverage B</u> <u>Other Structures</u>	<u>Coverage C</u> <u>Personal Property</u>	<u>Coverage D</u> <u>Loss of Use</u>
<u>HO 00 02</u>	Broad form \$15,000 min	Broad form 10% of A	Broad form 50% of A	Broad form 20% of A
<u>HO 00 03</u>	Open peril \$20,000 min	Open peril 10% of A	Broad form 50% of <u>A</u>	Open peril 30% of <u>A</u>
<u>HO 00 04</u> (Renters)	Not Applicable	Not Applicable	Broad form \$6,000 min	Broad form 20% of C
HO 00 05 (03 + 15)	Open peril \$20,000 min	Open peril 10% of A	Open peril 70% of A	Open peril 30% of A
<u>HO 00 06</u> (Condo)	\$1,000	Not Applicable	Broad form \$6,000 min	Broad form 40% of C
<u>HO 00 08</u> ACV	Basic \$15,000	Basic 10% of A	Basic 50% of A	Basic 10% of A

NOTE: Rental properties have DP 00 01, DP 00 02, and DP 00 03 which are analogous to HO 00 01, HO 00 02, and HO 00 03. DP=Dwelling Property

Insurance Planning Handout

Explain the difference between claims-made and occurrence-form professional liability insurance.

1. Occurrence-form insurance

Pays for claims based on coverage in effect when event "**OCCURRED**" regardless of when claim is made or presented to the insurer. The insurance company could be liable for claims made indefinitely after the policy period had lapsed. An "occurrence" policy covers the insured for alleged acts of negligence that occurred while the policy was in effect. It does not matter if the coverage is in effect at the time the claim is made. The benefit of occurrence coverage is that even if the insured cancels the policy at a future date, the insured will still be covered for events that occurred while the policy was in effect. Occurrence policies tend to have higher premiums than "claims-made" policies. Because of upheaval in the malpractice insurance market, occurrence coverage is becoming a rare commodity.

2. Claims-made insurance

The policy in effect when the claim is "**REPORTED**" determines the amount of loss regardless of when the event occurred. However, almost all policies will have a effective date where events occurring earlier are **not** covered. This is the most common today. A "claims-made" policy covers claims made against the insured only while the policy is in effect. The advantage is that premiums are based on actual claims experience. The disadvantage is that the policy must be continued indefinitely to assure coverage for claims filed in the future for actions that occurred in the past. If purchasing this type of policy, the insured should always look into "**TAIL**" **COVERAGE**, which covers the insured for claims made after policy expiration for incidents occurring during the policy period.

- 3. Tail Coverage - Extended Reporting Endorsement** (known as a "tail") Tail coverage is usually purchased when the insured terminates a claims-made policy for any reason and is purchased from the carrier that provided the original coverage. It allows the insured to continue reporting claims for the years that they were insured under the original policy.

Insurance Planning Handout

A. Define what is meant by replacement cost.

Replacement cost is the cost of **REBUILDING** the structure with materials of like-kind and quality at current prices. It can be computed using a construction cost index to original cost or using average costs in the area.

B. Identify the formula if less than eighty percent of the replacement cost is insured.

$$\frac{\text{Amount of insurance carried}}{80\% \times \text{market amount of insurance required}} \times (\text{Loss} - \text{Deductible}) = \text{Reimbursement}$$

(usually, this is replacement cost)

C. Example:

"X" has an HO-3 homeowner's policy with coverage of \$200,000 on her dwelling which has a replacement cost of \$300,000. The home has "qualifying" storm damage of \$30,000 measured by actual cash value but costs \$48,000 to replace.

Part A: Compute her recovery under the policy.

Part B: Compute her recovery if the ACV of the damaged property was \$45,000.

NOTE: Homeowners policies will generally pay the **GREATER** of the actual cash value (ACV) or the amount using this formula.

Insurance Planning Handout

Non-Forfeiture Options

Client "X" purchases an ordinary life insurance policy with a face value of \$100,000 at age forty. Fifteen years later he allows the policy to lapse. Using the attached non-forfeiture table, answer the following questions.

Part A: Compute the amount he would receive if he elects to withdraw the cash surrender value.

Part B: Compute the amount of reduced paid-up term, the cash value would purchase at forfeiture.

Part C: Identify the length of time the cash value could continue his current coverage as term.

Non-forfeiture Table (Dollar Values per \$1000 of Face Amount)

End of Policy Year	Cash or Loan Value	Paid-Up Insurance	<u>Extended Term Insurance</u>	
			Years	Days
1	\$ 0	\$ 0	0	0
2	10	50	3	165
3	20	100	6	120
4	35	150	8	255
5	45	200	10	270
6	60	230	12	160
7	70	270	14	35
8	85	305	15	285
9	100	340	17	45
10	115	375	18	70
11	130	404	19	15
12	145	435	19	250
13	160	465	20	70
14	180	495	20	215
15	200	520	20	320
16	215	545	21	30
17	235	570	21	75
18	255	590	21	95
19	275	610	21	90
20	295	630	21	70

Insurance Planning Handout

1. Describe the type of information used to evaluate an individual's life insurance needs.

Information about the individual and his or her family including AGES, income needs, educational needs, emergency needs, and retirement needs is used in evaluating an individual's life insurance needs. The three methods generally used are the human life value approach, needs approach, and the capital needs approach.

A. Human Life Approach - The financial value of an individual's life is considered the present value of future EARNINGS that is consumed by his or her dependents. Thus, it represents total earnings until retirement reduced by expected taxes and consumption of the insured.

B. Needs Approach - This method computes the financial needs of the insured's survivors and then purchases enough life insurance to generate that amount. Under this method, the principal sum is USED to meet these survivor needs. (FV = zero)

C. Capital Needs Approach - The capital needs approach is identical to the needs approach, except it PRESERVES the principal sum. For example, if \$30,000 annual income is needed and a 6% rate can be earned the amount of insurance needed under this approach is \$500,000. (Capitalization formula: $\$30k / 6\%$.)

D. List four methods of comparing costs between policies.

1. Belth Method
2. Linton Yield
3. Surrender Cost Index
4. Net Payment Index

E. Identify the formula used under the Belth Method.

$$\text{Policy cost per thousand} = \frac{(P + CVP)(1 + i) - (CSV + D)}{(F - CSV)(.001)}$$

Where:

P = Most current annual premium

F = Face of policy

CVP = CSV end of previous year

i = After tax rate of return

CSV = CSV end of current year

D = Most current annual dividend

F. Describe how this policy cost is evaluated.

The policy cost per thousand is compared with a table amount and if less than the benchmark figure, the premium is low. If more than **DOUBLE** the amount, the policy should be replaced.

G. Explain what is meant by the "traditional net cost method."

It is the predecessor of the net payment and surrender cost index, it ignores the **TIME** value of money. It merely takes the total **PREMIUMS** reduced by dividends and cash surrender value. This net cost is then divided by the number of years and computed per \$1,000 of coverage.

H. Traditional Method Example:

Policy "X" has a face value of \$50,000 and has an annual premium of \$1,000 and averages dividends of \$400 per year. Compute its cost per \$1,000 at the end of twenty years assuming its cash surrender value is \$10,000.

Total premiums for twenty years
Total dividends for twenty years
Net premiums
Cash surrender value
Net cost for 20 years
Cost per year (2,000/20 yrs)

Insurance Planning Handout

Explain what is meant by the “net” payment index.

The “net” payment index is a method for computing the **COST** of an insurance policy that considers the **TIME VALUE OF MONEY**. It is computed by subtracting the **FUTURE** value of the policy’s dividends from its premiums to obtain a net insurance cost.

A. Describe how the “surrender cost” index differs from the “net” payment index.

The “surrender cost” index assumes the policy will be **SURRENDERED** whereas the “net payment index” assumes the insured dies. Thus, the only difference is the surrender cost index subtracts out the **CSV** when computing the net insurance cost.

B. Net Payment Index Example:

An individual is considering the purchase of the following two \$50,000 policies. Given the following data using a 5% interest rate determine which policy is the most cost effective.

	Policy “X”	Policy “Y”
Annual premium.....	1,500	1,200
*Total dividends.....	12,000	10,000
Cash value (20 years).....	20,000	14,000
Dividends.....	600	500

*Assume that the premiums were paid and the dividends were received at the beginning of the year. Also, assume that Policy “X” dividends average \$600 per year and the “Y” dividends average \$500 per year.

	Policy “X”	Policy “Y”
Future value of premiums at 5% for twenty years.....	_____ (a)	_____ (b)
Future value of dividends at 5% for twenty years.....	_____ (c)	_____ (d)
Future value of net insurance cost.....	_____ (e)	_____ (f)
Less: cash surrender value.....	_____	_____
Net insurance cost.....	_____ (g)	_____ (h)

Solution Steps: Set Calculator to Beginning.

Premiums:

Policy X PMT < _____ > I _____ N _____ FV _____ **(a)**

Policy Y PMT < _____ > I _____ N _____ FV _____ **(b)**

Dividends:

Policy X PMT < _____ > I _____ N _____ FV _____ **(c)**

Policy Y PMT < _____ > I _____ N _____ FV _____ **(d)**

Net Cost:

Policy X \$52,079 - \$20,832 = _____ **Policy Y** \$41,663 - \$17,360 = _____

Net Cost:
Policy X \$31,247 - \$20,000 = _____ **Policy Y** \$24,303 - \$14,000 = _____

Insurance Planning Handout

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Dividends.....	600	500

*Assume that the premiums were paid and the dividends were received at the beginning of the year. Also, assume that Policy "X" dividends average \$600 per year and the "Y" dividends average \$500 per year.

	Policy "X"	Policy "Y"
Future value of premiums at 5% for twenty years.....	<u>\$52,079 (a)</u>	<u>\$41,663 (b)</u>
Future value of dividends at 5% for twenty years.....	<u>(20,832) (c)</u>	<u>(17,360) (d)</u>
Future value of net insurance cost.....	<u>31,247 (e)</u>	<u>24,303 (f)</u>
Less: cash surrender value.....	<u>(20,000)</u>	<u>(14,000)</u>
Net insurance cost.....	<u>\$11,247 (g)</u>	<u>\$10,303 (h)</u>

Solution Steps: Set Calculator to Beginning.

Premiums:

Policy X PMT <1,500> I 5% N 20 FV 52,079 (a)

Policy Y PMT <1,200> I 5% N 20 FV 41,663 (b)

Dividends:

Policy X PMT <600> I 5% N 20 FV 20,832 (c)

Policy Y PMT <500> I 5% N 20 FV 17,360 (d)

Net Cost:

Policy X \$52,079 - \$20,832 = **31,247 (e)** **Policy Y** \$41,663 - \$17,360 = **24,303 (f)**

Net Cost:

Policy X \$31,247 - \$20,000 = **11,247 (g)** **Policy Y** \$24,303 - \$14,000 = **10,303 (h)**

Insurance Planning Handout

Explain how annuities are taxed.

The investment income is not taxed until distributed to the policyholder. If before age 59½, there is an additional penalty of 10 percent. When taxed, the gain within an annuity will always be taxed as ORDINARY income.

NOTE: Death, disability, and substantially equal payments over life expectancy are all exceptions to the 10 percent penalty for annuities.

A. Identify the formula used to compute the amount nontaxable under the general rule.

$$\begin{array}{l} \text{Nontaxable return} \\ \text{of capital} \end{array} = \text{Payment} \times \frac{\text{Investment in contract}}{\text{Expected return}}$$

B. Example:

Individual "X" purchases an annuity for \$36,000 that will pay her \$1,000 per month for life when she reaches age 70. At age 70 her life expectancy is 12 years. Compute the amount she will include in income each year under the contract.

Amount Excludable:

Amount Taxable:

NOTE: If she lives beyond 12 years, the ENTIRE amount will be taxable. The life expectancy is from IRS tables V – VIII for annuities funded after 6-30-86 (unisex tables).

C. Identify the formula for a variable annuity.

$$\begin{array}{l} \text{Nontaxable return} \\ \text{of capital} \end{array} = \text{Payment} \times \frac{\text{Investment in contract}}{\# \text{ of years or payments for expected return}}$$

D. Example:

Same facts as Example B above except "X" purchases a variable annuity and the monthly payment is unknown.

11. Define what is meant by a structured settlement.

An agreement by which someone who is entitled to receive a lump-sum payment elects to receive the money in the form of an ANNUITY. Often arises in compensating individuals in a medical malpractice or automobile accident lawsuit.

A. Identify the advantages of structured settlements.

The primary advantage is its income tax treatment which treats both the principal and interest payments as a TAX FREE injury damage. Other possible advantages include the professional

MANAGEMENT of funds and benefit payments that match cash needs.

B. Describe the disadvantage of structured settlements.

The insurer issuing the annuity used to pay the structured settlement might become

INSOLVENT. Also, it may be difficult to match the annuity payments with the cash needs of the payee.

Insurance Planning Handout

Example:

Individual "X" purchases an annuity for \$36,000 that will pay her \$1,000 per month for life when she reaches age 70. At age 70 her life expectancy is 12 years. Compute the amount she will include in income each year under the contract.

Amount Excludable:

$$\frac{36,000}{1,000(12)(12)} = \frac{\$36,000}{144,000} = 25\%$$

Amount Taxable:

$$12(1,000)(.75) = \$9,000$$

NOTE: If she lives beyond 12 years, the **ENTIRE** amount will be taxable. The life expectancy is from IRS tables V – VIII for annuities funded after 6-30-86 (unisex tables).

C. Identify the formula for a variable annuity.

$$\begin{array}{l} \text{Nontaxable return} \\ \text{of capital} \end{array} = \text{Payment} \times \frac{\text{Investment in contract}}{\# \text{ of years or payments for expected return}}$$

D. Example:

Same facts as Example B above except "X" purchases a variable annuity and the monthly payment is unknown.

$$\frac{36,000}{12(12)} = \$250 \text{ PER MONTH TAX FREE}$$

Insurance Planning Handout

Match each of the following coverage types with its correct description.

- | | | |
|----------------------|--------------------------------|--------------------|
| 1. Actual Cash Value | 3. Guaranteed Replacement Cost | 5. Valued Coverage |
| 2. Cash Payment | 4. Replacement Cost | |
- a. Pays the entire amount to replace the damaged property up to the policy limits.
- b. Pays the entire amount to replace the damaged property regardless of cost.
- c. Pays a fixed dollar amount regardless of loss such as life insurance policies.
- d. Pays a fixed dollar amount based on the value of the property at the inception of the policy.
- e. Pays the damaged property's replacement cost reduced by an allowance for depreciation.

SOLUTIONS:

Match each of the following coverage types with its correct description.

- | | | |
|----------------------|--------------------------------|--------------------|
| 1. Actual Cash Value | 3. Guaranteed Replacement Cost | 5. Valued Coverage |
| 2. Cash Payment | 4. Replacement Cost | |
- a. 4 Pays the entire amount to replace the damaged property up to the policy limits.
- b. 3 Pays the entire amount to replace the damaged property regardless of cost.
- c. 2 Pays a fixed dollar amount regardless of loss such as life insurance policies.
- d. 5 Pays a fixed dollar amount based on the value of the property at the inception of the policy.
- e. 1 Pays the damaged property's replacement cost reduced by an allowance for depreciation.