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Guide to Risk Management and Insurance

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Guide to Risk Management and Insurance

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NOTICE TO READERS

The *Guide to Risk Management and Insurance*, prepared by the Personal Financial Planning (PFP) Risk Management Task Force, has been published as the Risk Management and Insurance module of the looseleaf AICPA *Personal Financial Planning Manual*, as it appears in the December 1991 update.

The nonauthoritative practice aids in this guide do not present positions but attempt to offer some alternatives that practitioners can choose from and then modify, if necessary, to meet their needs. They are intended as time-saving illustrations and tools. They are not intended to establish standards or preferred practices. Authoritative technical literature should be consulted in carrying out all engagements, including personal financial planning engagements.

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Guide to Risk Management and Insurance

American Institute of Certified Public Accountants

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PREFACE

The Personal Financial Planning Division has prepared this manual of nonauthoritative practice aids to assist certified public accountants in the efficient and competent delivery of personal financial planning services to their clients.

This practice aid is intended for practitioners who are developing comprehensive personal financial plans as well as those performing segmented planning and consultation engagements. This guide contains previously released material that was distributed as part of the December 1991 update to the *PFP Manual.*

RISK MANAGEMENT AND INSURANCE
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3/500 RISK MANAGEMENT AND INSURANCE

3/505 INTRODUCTION

.01 The generally accepted definition of risk is the possibility of harm, injury, loss, danger, or destruction. Risk can be further subdivided into two basic types: *speculative risk* and *pure risk*. Speculative risk has the potential for loss, no loss/no gain, or gain. Pure risk, however, has no opportunity for gain; it can only produce loss or no loss. Insurance is only concerned with pure risk.

.02 All pure risks exist because of *perils*, which are the actual causes of loss. Perils, such as death, disability, illness, fire, accident, theft, lawsuit, and dishonesty, are all high-risk situations. *Hazards* are acts or conditions that could increase the likelihood or severity of a loss. Gasoline-soaked rags under a wooden staircase increase the likelihood of fire: those rags are a *hazard*, which increases the likelihood of the *peril* of fire. It is important to distinguish between the two.

.03 For example, if a client does not screen employees and leaves money lying around the office, the risk of going from a no-loss situation to a loss situation increases. *Peril:* The possibility of a dishonest employee causing an actual loss of money. *Hazard:* The lack of employee screening and the careless handling of money.

.04 Hazards are normally classified as physical, moral, or morale. The physical hazard is the money lying around the office instead of being in a safe place. The moral hazard is the mental attitude of the dishonest employee. The morale hazard is the carelessness of the person responsible for the safekeeping of the money.

3/510 PERSONAL RISK MANAGEMENT

.01 It is very common for major corporations to employ risk managers. The risk manager's duty is to identify and manage the various risks that corporate employers are exposed to; that is, to select the best strategy for living with or eliminating the risks. It is, however, rare for an individual to have a personal risk manager; more often, a CPA or insurance professional fills that role.

.02 Personal risk managers apply the same principles to personal situations. They seek out and try to eliminate hazards that could contribute to or increase the possibility of perils. This should achieve the goal of reducing the risk of financial loss. The process involves determining the probability of a peril's occurrence and the size of a potential loss. With this information, the CPA, insurance professional, and the person at risk (client) then decide on the appropriate method:

- **Risk control:** Minimizing losses,
- **Risk financing:** Reducing the cost of losses that occur, or
- **Combination:** Employing both risk control and risk financing.

3/515 IDENTIFYING RISKS

Step 1: Fact Finding

.01 The better a CPA or insurance professional knows the client, the easier it is to identify the client's risks. Thus, the client's personal data gathering forms (see exhibits 3/500-1 to 3/500-3), including inventories of assets and liabilities and cash flow, should permit the identification of most of the perils arising from family relationships, such as death or disability; from ownership of property, such as fire or theft; from debt, such as creditors insisting on payment despite the client's circumstances; and from reduced cash flow because of death, disability, or major illness.

Step 2: Life-Style

.02 A careful evaluation of the client's life-style is important to identify risks. The fact that the client is an ardent hang glider or races snowmobiles for a hobby could suggest some types of risks. Other risks are suggested by a client's expressed hope to become the president of the local chamber of commerce or to be elected to public office.

Step 3: Existing Insurance

.03 The client's existing insurance policies identify the risks the client is aware of. Reviewing them can help the risk manager determine the adequacy of protection for identified risks, and exposure for potential risks that lack coverage (see exhibit 3/500-4).

Step 4: Client Cooperation

.04 The better the knowledge of the client, the easier it is to identify the client's risks. Thus, it is important to discuss all unclear matters and other concerns with the client in complete candor. These concerns include things that might be difficult for a client to face, such as the mental competency of children or the ability of a child or spouse to handle money. Although this can be difficult to do, a discussion of risks in clear, concrete language gives the client the opportunity to open up and to respond to the important questions underlying successful risk management.

3/520 EVALUATING RISKS

.01 After the risk-identification process is completed, it is necessary to evaluate the client's exposure by considering the potential severity of loss and the potential frequency of occurrence. The use of an objective form (see exhibit 3/500-5) can be of assistance in making these determinations.

.02 It should now be possible to classify potential losses as:

- **Critical:** An occurrence that could lead to bankruptcy
- **Important:** An occurrence that could lead to negative alterations in a family's life-style
- **Material:** All other risks

Once the risks are classified and understood, the client has the opportunity to decide how they should be managed.

3/525 RISK TREATMENT STRATEGIES

.01 There are two basic methods for treating risk: *risk control* and *risk financing*. Further, there are four strategies for implementing these methods, each strategy with its own tools. The strategies are:

- **Risk avoidance:** Eliminate hazardous activity.
- **Risk reduction:** Improve safety, pool or combine exposed activities, segregate activities, and diversify activities.
- **Risk transfer/share:** Transfer or share some or all the risk with another person, an insurer or society.
- **Risk retention:** Retain an acceptable portion of the risk through high deductibles, extended waiting periods, and co-insurance, while transferring or sharing the remainder of the risk.

Risk Avoidance

.02 Avoiding risk is an appropriate strategy for high frequency and high severity risks. To adopt the risk avoidance strategy, the client must be willing to give up something. Thus, the tools of risk avoidance strategy are: do not own, do not do, do not say, and, therefore, do not expose yourself to risks. This is a direct application of risk control. For example, a CPA could suggest to a client that risk avoidance is the best strategy available for handling the risks associated with hang gliding. Adopting this strategy says: do not own a hang glider, do not use a hang glider, and do not expose yourself to the risks associated with hang gliding. The frequency of hang gliding accidents and the associated severity of those accidents is high. Thus, the best strategy is: avoid the risks associated with hang gliding.

Risk Reduction

.03 A client who does not want to avoid the risk might agree to *reduce* the associated risks, a strategy appropriate for all high-frequency risks regardless of their severity. The tools used in risk reduction are to adopt safety procedures, pool, segregate, and diversify.

.04 Safety. The client can establish safety procedures and take precautionary measures to reduce the risks associated with potentially dangerous activities, such as hang gliding.

.05 Pooling. Pooling, or combining the exposure to loss with others similarly placed, distributes the risk among the group. When a loss does occur to one, all the others join in paying the loss. This reduces the financial impact of the loss on any one member of the pool. For instance, if a chamber of commerce has had difficulty in getting liability insurance for its directors and officers and it joins with other chambers of commerce to purchase the insurance, there has been a pooling.

.06 Segregation. Segregation prevents a single event, for example, a plane crash, from causing an overwhelming disruption to a business or a family. Examples of using segregation to reduce risk would be for a CPA to suggest that a client's key employees not fly together on the same plane or that clients and their spouses take separate flights when going on vacation.

.07 Diversification. Diversification divides the existing risks among different units so that each unit cannot be made to bear the burden of the risk of another unit. Thus, for example, a client could use diversification to reduce risk by setting up several different corporations to carry out the various functions presently performed by one existing corporation.

Risk Transfer/Share

.08 Transferring/sharing risks is an appropriate strategy for risks that occur with low frequency but are of high severity. To interpret transfer/share as literally removing the risk completely and putting the risk on someone else is unrealistic. In most cases, the best available strategy is to *transfer* some of the risk by *sharing* the risk with someone else: society, government, insurance companies, or other individuals. Renting rather than owning; insurance contracts; service contracts (beyond warranty period); governmental programs, such as Social Security and workers' compensation; credit arrangements; and *hold harmless* arrangements are examples of risk transfer/share.

Risk Retention

.09 The risks that are appropriate for an individual to retain are those risks that occur frequently but are of low severity. These risks are generally difficult to insure economically because of the cost of handling frequent claims. Indeed, the cost of transferring these risks to an insurance company may well exceed the dollar amount of the losses themselves.

.10 Loss retention is a strategy that can be implemented using the tools of deductibles, waiting periods, and co-insurance. Risks that cannot be transferred/shared yet voluntarily not avoided must be retained. Thus, when a client insists on continuing to hang glide or to operate a snowmobile, a decision has been made to ignore the risks or to retain the risks associated with the activity or ownership.

3/530 INSURANCE

Introduction

.01 Generally, insurance is said to have two fundamental characteristics. The first is that it transfers/shifts risk from an individual to a group. The second is that it provides a means for paying for losses. Because insurance provides an important means of preventing risk from interfering with a client's achieving financial objectives, it is useful to look at the principles underlying insurance. The concepts of insurance and the types of frequently encountered insurance coverage are reviewed below.

How Insurance Works

.02 The first principle of insurance is the pooling of a large number of homogeneous units about which it is impossible to predict losses individually but is possible to predict losses for the pool. The pooling of the similar risks increases the predictability of the losses that could occur to the group.

.03 For example, actuaries can determine with reasonable accuracy how many houses will burn in the United States next year. Actuaries will tell you with reasonable accuracy how many men age thirty five, who are nonsmokers, will die in the coming year. What they cannot tell you are which houses will burn and which thirty-five-year olds will die. But with a large number of homogeneous units the actuaries can allow *the law of large numbers* to work for them to predict with accuracy the number of losses that may occur. Once the loss experiences of the pool are known, rates can be developed to assure that the premiums collected from the pool are adequate to pay the claims (losses) of the pool.

Insurable Risk

.04 Before an insurance policy will be written, there must be an insurable risk. To be insurable, the risk must be:

A. Part of a large number of homogeneous units;
B. Definite and measurable (the insurer must be able to determine that a loss has occurred and to accurately measure the economic impact of the loss);
C. Fortuitous or accidental (the insurer will only cover losses on the chance of loss or no loss, but not on the certainty of loss, which would be the case of an intentionally caused loss); and
D. Other than catastrophic (the risk cannot eliminate the total pool of homogeneous units or produce such widespread devastation as to wipe out an entire area).

3/535 INSURERS

.01 An insurer bears the burden of another party's risk in return for the payment of a consideration: the premium. Using insurers is probably the most popular technique in risk management. Insurers come in many forms: for-profit companies, mutual (for benefit of policyholders) companies, cooperative insurers, and the federal and state governments.

Private Insurance Companies

.02 There are several thousand private insurance organizations that, for the payment of a premium, will agree to pay the insured for damages resulting from the risks the insured has transferred/shared.

.03 The insurance companies are classified as either profit seeking or non-profit seeking. Stock insurance companies, that is, companies owned by shareholders who expect to receive a return on their investments, constitute the major segment of the profit-making segment. Mutual insurance companies, owned by the policyholders — the insurers — are the most important nonprofit companies. No conclusions can be drawn about the quality of the company from its form of organization. Solvency, cost of premiums, service, and other factors described below should be considered when choosing an insurance company.

Cooperative Insurance

.04 Cooperative insurance, as distinguished from insurance provided by for profit or mutual companies, provides insurance to members of an underlying association as a corollary benefit of association. Cooperative insurance provides a needed benefit, which could otherwise either be difficult to obtain or more costly, for the good of the association members. Cooperative insurance is commonly provided by hospitals (Blue Cross), medical groups (Blue Shield), fraternal organizations, trade unions, and trade associations. If a client is a member of an organization that provides cooperative insurance, it could be a financially advantageous means of pooling the covered risks.

Government Insurance

.05 Social Insurance. Social insurance is required by law, is government administered, and is concerned with social adequacy. The general design of social insurance is to provide a minimum of economic security for a large group of people. The risks covered are those that private insurance typically inadequately provides. Examples of social insurance include the following:

- Social Security, which includes old age, survivors, disability (OASDI), and medicare
- Workers' compensation, including temporary disability
- Unemployment compensation
- Automobile insurance provided by state-mandated pools
- Railroad retirement, unemployment, and disability systems

The cost, a premium or tax, of providing social insurance benefits is mandated by law, as are the benefits. The recipients of the benefits generally contribute all or a part of the cost.

.06 Public Assistance. Although similar to social insurance, public assistance differs because the recipients of the benefits do not contribute to the cost providing the benefit. Society as a whole is charged with the cost of providing the benefits. Public assistance programs include old age assistance, aid to the blind and dependent children, Medicaid, and welfare in all its forms.

.07 Public Insurance. Public insurance is established to benefit the whole community but is only used by those who wish to gain the benefits. It is a government pooling vehicle that is not compulsory. Some of the best known examples of public insurance are the following: Federal Housing Authority (FHA) insured mortgages, federal crop insurance, veterans and military life insurance, deposit insurance, and flood insurance. Public insurance (and compulsory social insurance) is the governments' and insurance industry's way of saying the losses involved are potentially so widespread and large that private insurance cannot provide the minimum level of coverage society determines is necessary. Society fulfills its perceived obligation by either mandating the insurance and related costs or by making the insurance available to those wishing to participate.

3/540 BONDS

.01 A bond is a contract or agreement under which a party (the surety, usually a bonding company) agrees to answer to another party (the obligee) for the default, failure to perform, or dishonesty of a third party (the principal). Thus, when the principal breaks the terms of the bond, that is, fails to perform, the surety pays the obligee the amount stated in the bond.

.02 Fidelity Bonds. A fidelity bond protects an obligee, who is usually the principal, against employees' dishonesty. Fidelity bonds are commonly required of employees who handle large sums of cash or other easily negotiable property, such as securities or gemstones.

.03 Surety Bonds. Surety bonds pay a specified amount of money on the failure of performance set forth in the bond. Surety bonds are commonly demanded of people seeking certain licenses, such as insurance agents and registered investment advisers; people under order to appear in court; and people or organizations required to perform a specific act, such as construction work under a contract.

3/545 COST OF INSURANCE

.01 Insurance has a cost that is generally expressed through the *insurance equation:*

Premium Income + Investment Income = Claim Costs + Expenses + Profit

Insurance companies can only continue when the equation is in balance. If the private insurance sector cannot keep the equation in balance, and the society deems the insurance necessary, government will be asked to step in to provide social or public insurance.

Government can do this because it is not constrained by the insurance equation.

3/550 THE CPA'S ROLE IN RISK MANAGEMENT

.01 The CPA has a unique opportunity to help clients both by identifying the risks that can keep the clients from attaining their personal financial goals and by structuring a plan of action to assure that the risks are adequately protected against through insurance or by using other risk-management strategies. The information generated in developing a comprehensive financial plan, such as a list of assets and liabilities, cash flow sources and requirements, personal objectives, estate liquidity needs, investment objectives, and portfolio composition, are essential reference points used to develop and implement a risk-management and insurance program for the client.

Periodic Risk-Management Analysis

.02 The periodic review of a client's risk exposure and the management of that exposure, such as through current insurance coverage, is desirable. It allows the CPA to develop recommendations for the client to consider in managing exposure to a changing risk environment based on the strategies previously described. The desired result is a client who is adequately and properly protected but not overinsured or overcharged. Also, periodic review helps a client understand that life changes, such as a job change or divorce, affect risk management and insurance coverage. (See exhibit 3/500-6 for a model transmittal letter.)

.03 Another reason for a periodic review is that the insurance industry is not static. New products, which continually come onto the market, might better fit the client's needs at a more favorable cost. Thus, the CPA should consider periodically reviewing existing coverage in the light of changing product lines. Some CPAs have their clients regularly request information from their insurance professionals.

Practice Management

.04 Professional Standards. Under current professional standards, when providing advice in the risk-management/insurance area, as in all practice disciplines, the CPA must be competent and knowledgeable. These materials help provide both an educational background and an overview of planning techniques and strategies.

.05 Some CPAs find it helpful to develop a relationship with one or more insurance professionals who can review overall risk-management strategies. Of course, it is important for the client to grant permission before discussing or releasing any confidential information to anyone outside the CPA's firm.

.06 Licensing as an Insurance Agent. Many states regulate the giving of insurance advice and require licensing before advice can be given for a fee. All states, however, require licensing when the advice is given for compensation from a commission through the placement of an insurance policy.

.07 When a CPA renders risk-management or insurance advice rather than recommending specific policies within the context of a PFP engagement, most state regulations exempt the CPA from the insurance licensing requirements. This is also often the case when the insurance discussion is provided as part of a CPA's traditional responsibilities. Therefore, before advising clients, a CPA should consider checking the specific regulations of the state(s) involved and possibly seeking the advice of legal counsel. Further information on state regulation can be found in services, such as *The Advanced Sales Reference Service* [The National Underwriter, (800) 543-0874], or by contacting the insurance commissioner of the particular state or the National Association of Insurance Commissioners at (816) 842-3600.

.08 **Accepting Commissions.** The AICPA ethics rules allow members to receive commissions from the sale of insurance products provided the CPA is not performing an attest service for that client. Most state accountancy boards continue to prohibit commission arrangements. As previously noted, a CPA may be required to secure the appropriate insurance license from the state insurance commissioner before a commission can be accepted for the sale of an insurance product.

.09 **Engagement Letters.** Many CPAs use specific provisions in the engagement letter to outline the scope of the risk-management/insurance advice that will be rendered. Generally, this advice is limited to generic advice rather than specific policy recommendations. Many engagement letters also state that the client's insurance professional will review all insurance advice given as part of the planning engagement. The following are sample insurance-related engagement-letter clauses.

A. Insurance recommendations developed as part of your financial plan or to implement your financial plan should be made by a licensed insurance adviser of your choice. We are not responsible for the success or failure of any specific policy or insurance strategy recommended by your advisers.
B. It is agreed and understood that [firm name] will not accept or receive fees, commissions, or other remuneration or compensation from the originators, distributors, or sellers of insurance products purchased by you.
C. We cannot be responsible for the acts, omissions, or solvency of any broker, agent, independent contractor, or other adviser selected in good faith to take any action or to negotiate or consummate a transaction for your account. Our services are not designed to be nor should they be considered to be a substitute for your own business judgment. Further, they are not meant to relieve you of the necessity of personally reviewing and analyzing a particular insurance product. Our role is to coordinate your financial plan; we are not, however, insurance salespersons or insurance brokers. Our services are designed to supplement your own planning analysis and to aid you in fulfilling your financial objectives.
D. Our services are not designed to discover fraud, irregularities, or misrepresentations made in materials provided to us concerning your insurance coverage.

E. You are, of course, free to follow or disregard, in whole or in part, any recommendations we may make. You are responsible for any and all decisions regarding the implementation of the recommendations. At your request, we will coordinate the implementation of your insurance program with any insurance agent of your choice.

(See pages 1-19 through 1-24.2 of the *PFP Manual* for complete sample engagement letters.)

3/555 INSURANCE SALESPEOPLE AND THEIR COMPANIES

Selecting an Insurance Professional

.01 A client, with a CPA's assistance, can select an insurance professional by evaluating the professional's reputation for integrity; education, training, and experience; professional designations; scope of products; and method of compensation. The client should understand the importance of an insurance professional's experience in insurance, including: any designations, such as Chartered Life Underwriter (CLU) or Chartered Property and Casualty Underwriter (CPCU); relations with any companies or brokerages; methods of providing services; plus any other business experience.

.02 Many insurance professionals are *independent agents*, free to choose from the products offered by many companies; they are not limited to one company's products. Theoretically, independence allows the insurance professional to find the best match between client and product. Because of the vast number of products and companies, however, it is extremely difficult, if not impossible, for any one insurance professional to be knowledgeable about all available products. Thus, many independent insurance professionals concentrate their efforts on the products of a limited number of companies.

.03 An alternative to the independent insurance professional is a professional insurance consultant who is paid a flat fee to review and design an insurance program. The fee is not based on the purchase of specific products, resulting in a high degree of independence. However, because the consultant is not compensated on an ongoing basis, there can be a lack of motivation to update coverage and to review the appropriateness of specific policies. This can be contrasted to the belief of some clients that their continuing relationships with their insurance professionals, who are compensated by commissions on the placement of additional policies, help to assure that there are continuing reviews of the clients' coverages.

.04 If a client has a special underwriting problem, seeking an insurance professional who has the ability to obtain coverage that deals with the underwriting problem is important. The insurance professional should have access to those companies that specialize in handling difficult underwriting cases, such as health or life coverage for individuals in poor health or in high-risk occupations.

Selecting an Insurance Company

.05 A client may ask a CPA to assist in selecting an appropriate insurance company. This decision-making process is influenced by four factors:

A. The match between the products offered and the client's objectives, including the existence of sufficiently diversified products to meet the client's future needs.
B. The integrity and financial strength of the company.
C. The qualitative features of the company's performance, such as the type of service the company would render to the client.
D. The price the company charges for a particular coverage.

.06 Many insurance professionals advocate that their clients deal only with the largest insurance companies. A conglomerate whose main business is not insurance could easily terminate an underperforming insurance division. An underwriter whose primary business is insurance is more likely to stay with a product line that has problems.

.07 The issues involved in product matching are covered in the remainder of this module. However, there are services (for example, Insurance Information Inc., 134 Middle Street, Lowell, MA 01852, 617-453-2557) that actually provide a client with a list matching the most competitive companies that market the type of product the client wants. A comparison between companies and products helps determine which best fit the client's needs.

.08 Integrity and Financial Strength. Historically, the starting point used to evaluate an insurance company's financial strength was the rating given by the A. M. Best Company (Ambest Road, Oldewick, NJ 08858) in its *Best's Review*, which rates insurance companies in four areas: underwriting, expense control, reserve adequacy, and investments. Ratings range from A+ to C—. Approximately 50 percent of all companies rated by Best receive a rating of A or A+. Based on this, some commentators suggest that there is no reason to deal with a company that does not have at least an A rating, that is, one in the top 50 percent. Other widely used sources of information on the strength of insurance companies are Standard & Poor's Insurance Rating Services, 25 Broadway, New York, NY 10004; *The Insurance Forum*, P.O. Box 245, Elletsville, IN 47429; *Moody's Bank & Finance Manual*, Moody's, 99 Church Street, New York, NY 10007; Duff & Phelps Credit Rating Company.

.09 It is also important to review a company's rating history to determine if there has been a change in rating. A company whose rating has dropped could be more risky than a company with an improved rating, even though the latter's new higher rating is lower than the declining company's rating. A change in rating could be a flag indicating that additional investigation is necessary.

.10 When relying on a rating service, it is important to understand the basis on which the review was performed. Many of the terms and assumptions used for insurance companies have meanings that differ from traditional accounting definitions. Insurance company annual statements are based on historical information and are presented on the basis of *statutory accounting*, which is generally considered to be more conservative than *generally accepted accounting principles* (GAAP).

.11 Another indication of an insurance company's integrity is the states in which it actually conducts business. If a company does business in a state with high regulatory standards, such as New York, some comfort can be derived from this information because the company must conform to the standards imposed by the state.

.12 **Financial Statements.** An insurance company's annual reports are a good source of information. By carefully reading the financial statements, a CPA can often spot red flags, keeping in mind that the information is historical.

.13 **Qualitative Considerations.** Evaluating the qualitative features of an insurance company can be difficult. It entails a review of areas, such as the following:

- Speed of service of underwriting, annual servicing, and claims processing.
- Quality and accuracy of the above services.
- Performance of the agent and other company employees.
- Geographic availability of the desired services.
- Underwriting requirements.

3/560 LIFE INSURANCE

The Basics

.01 Life insurance is a risk-sharing mechanism whereby a policy owner (the insured) agrees to invest some money with an insurance company that obligates itself to pay money to a beneficiary on the insured's death.

.02 If this concept of life insurance is accepted, it becomes very easy to understand that:

- Insurance companies do not give away *net amount at risk* or *life insurance* free. They charge each insured for the expenses associated with providing life insurance each year so that the sum of the charges to each insured is sufficient to pay the administrative expenses and the benefits the insurance company expects to pay each year. The charge for benefits is called a mortality charge. The cost of term insurance is derived by combining the mortality charge and the expense charge.
- Policy owners pay the expense and mortality charges each year because they want and value the delivery of the insurance company's money, "life insurance," to the beneficiaries at the insured's death.

.03 Internal Revenue Code (IRC) Section 7702 defines *life insurance* for income tax purposes in terms of requiring a *net amount at risk*. The *net amount at risk* or life insurance is, "only the excess of the amount paid by reason of the insured's death over the contract's net surrender value." IRC Section 7702 requires that the net amount at risk exist in sufficient amounts before a contract could be deemed to be life insurance for tax purposes.

.04 It is not likely that the CPA would be personally concerned about an insurance policy failing the IRC Section 7702 tests. It could be expected that all insurance companies have established procedures to make sure that none of their life insurance policies fail any of the IRC Section 7702 tests and thus fail to be life insurance contracts. However, it could often be the policy owner's and the CPA's responsibility to make sure the policy does not fail the IRC 7702 tests.

.05 The point is that the tax law demands a substantial amount of risk in order to differentiate an insurance policy from other kinds of property so it is eligible for favorable tax treatment. What makes a life insurance policy unique is that there is an amount at risk and that the consumer is paying for the insurance company to accept the obligation to pay insurance-company money, (the net amount at risk life insurance), to the beneficiary in the event of an insured's death.

.06 The CPA's Role. The CPA's role in life insurance planning is growing because of the ever-increasing complexity of life insurance contracts. Many clients are seeking the objective advice of their CPA to help sort through their options and to arrive at solutions. The CPA works with the client to determine the amount of life insurance needed. This is based on risk exposure resulting from death. Once the amount of insurance needed has been determined, the CPA could consider consulting with a life insurance professional regarding the type of life insurance policy most suited to the client's needs.

.07 The CPA could also consider reviewing a client's existing life insurance policies as well as proposals for new insurance presented to the client by the insurance professional. It is important that the CPA work in conjunction with the insurance professional, and often the client's attorney, during each stage of the life insurance planning process.

.08 The CPA's role is often critical in working through and understanding competing proposals from one or more insurance professionals. The client depends on the CPA's objectivity and judgment for guidance.

.09 Life Insurance Inventory. The first step in life insurance risk management is understanding what is available from the insurance companies to assist in offsetting the economic losses associated with a person's death. The next step is to inventory what is already owned. A life insurance inventory page is completed for each policy owner. This form (see exhibit 3/560-7) is structured so that the CPA can record all the essential information needed to analyze the policies for adequacy of amount and to evaluate the investment merits of the policies used for that purpose.

.10 How Much Is Enough? The question of how much is enough is very personal. The first question that comes up is: In the event of an individual's death, would someone else incur an economic loss? If the answer to that question is yes, then the second question is: Is there someone who cares to reduce that economic loss by purchasing life insurance on the insured's life so that the insurance dollars would be available to mitigate that loss? The desire for life insurance can come from a business or a personal relationship.

.11 In personal financial planning, the CPA is primarily concerned with determining the reasonable level of life insurance for a family. The Life Insurance Needs Analyzer (see exhibits 3/500-8 to 3/500-11) could operate as a checklist to help a client make this determination. The first section of the form deals with the immediate expenses on death, and some of the earmarked, reserved, or sinking funds that a family that lost a principal breadwinner may want to establish for future purposes, such as education and emergency funds five years after the death of the insured. The underlying theory is that the surviving spouse may be able to find other means of support after that period of time.

.12 The second section of (exhibit 3/500-8) deals with survivor's incomes and splits the income requirements of a family into three different periods. The first is the period when there are children under age eighteen in the home. The second period is after the youngest attains age eighteen and prior to the surviving spouse's attaining age sixty-two, which is the earliest time that the spouse can then draw Social Security. The third and final period is the post-sixty-two or -sixty-five year period for the surviving spouse and continues on for the rest of the surviving spouse's life. This is often called the *blackout period*. The determination in this area is for how much income the client wishes the surviving spouse to have. The amount of capital required for each of the three periods is found by computing the present value of the income requirement and some assumed interest rate or discount rate so that the discounted present value of that stream of payments can be determined. This calculation is summarized in exhibits 3/500-9 and 3/500-11.

.13 Provision has been made on the form for deducting the other sources of assured income that a surviving spouse may have, such as Social Security, if there are dependent children under the age of sixteen (benefits for children between sixteen and eighteen are payable to the children), and other sources of income, such as the spouse's earned income, income from employee benefit plans, and other survivor income plans.

.14 The funds to generate the desired income are then added to the funds that should be available after death for cash expenses and sinking funds, to arrive at an amount of money that could accomplish all family objectives. The next task is to compare what the family has available to this figure, which represents what is required. To do this, add up the life insurance that would be available, the amount of the family's investable capital that would be available, the amount of all retirement-plan-generated cash, and any other assets that would be available to provide security for this family. Then subtract what is available from what is required to come up with the amount of additional life insurance that should be considered.

.15 When to Use? Because of the unique nature and tax benefits of life insurance, there are many different uses for it in a client's portfolio. The uses for life insurance can be broken into two broad categories: personal and business. Typical uses of insurance are summarized in the following chart.

Personal Uses	*Business Uses*
Debt liquidation	Buy/sell agreements
Spouse or family income	Key person insurance
Estate liquidity	Executive perks
Education funding	Deferred compensation
Bank guarantees	Death-benefit-only unsecured loans

.16 Determining Life Insurance Needs. The most common determination a CPA makes is to compute the dollar amount of life insurance an individual needs to provide adequate security for a surviving spouse and children. In addition to several rule-of-thumb methods, such as four to six times earnings, there are several accepted methods of calculating this amount that strive for more precision. Chief among them are the following:

- Human value approach
- Adjustment period capital needs analysis
- Lifetime capital needs analysis

.17 The *human value approach* is based on the economic value of the insured's ability to earn income. It is the present value of the future stream of cash flow that the insured may generate. For an employee, that future stream of income would simply be the annual salary, adjusted for inflation. For a business owner or professional, the methodology is the same, although predicting the cash flow can be much more difficult. This approach usually results in a fairly high need for insurance and is often used to establish the upper limit of insurance needs.

.18 The *adjustment period capital needs analysis* is based on the desire to provide a specified level of income to a surviving spouse for a short period of time.

.19 The *lifetime capital needs analysis* is similar to the adjustment period capital needs analysis except that it is based on providing a level of income for the spouse's life expectancy. It is important that the life expectancy should be considered a minimum time period. The CPA could consider pointing out to the client that this may or may not be an appropriate assumption because a person could live for a significant period beyond the projected life expectations shown in various mortality tables.

.20 The lifetime capital needs analysis examines two separate needs: cash needs and income needs. Examples of cash needs would be payment of death taxes, mortgages and other loans, funeral expenses, and establishment of a reserve fund for children's future college education expenses. Income needs are dictated by the client's present life-style. Once the level of the current living expenses of the client and spouse is determined, the surviving spouse's income needs can be estimated, using a percentage (60 to 80 percent) of their current living expenses. A percentage of current expenses is used because certain expenses, such as food, clothing, and automobiles, may drop off or decrease for the surviving spouse. From this amount, subtract the surviving spouse's other sources of income, such as Social Security and salary, to get the net monthly income need.

.21 The amount of cash required to fund the net monthly income need is the present value of that projected income stream over the survivor's life expectancy or for a period of years. If inflation protection is an objective, it is important to increase the income stream each year at a rate to offset inflation. The resulting cash fund arrived at when compared to the present life insurance benefits should represent either the client's need for additional life insurance or the amount by which the client is overinsured.

The Life Insurance Contract

.22 Life insurance is a contract (policy) that promises to pay a specified amount of money to a designated beneficiary when the insured dies. The contract is between the insurance company and the policy owner, who pays premiums in exchange for promised death benefits. Frequently the policy owner is the person insured, but the policy can also be owned by someone other than the insured.

.23 The insurance company charges a premium (the consideration) for the contract. This premium is combined with premium payments on other contracts. Earnings on the investment of these premium payments provide adequate funds to pay death benefits and cover insurance company expenses and profits. Consequently, the death benefit can be significantly larger than the premium paid for an individual policy.

Types of Life Insurance (See exhibit 3/500-13)

.24 **Term Insurance.** Term life insurance is insurance for a specified period of time, such as one year, five years, ten years, or to a specified age, such as sixty-five. At the end of the specified period, the contract expires. If the policy is renewable, continuing coverage can be obtained by renewing the term insurance policy for another successive period and paying the new, higher premium applicable to the insured's new attained age. For one-year term, insurance (also called *YRT* yearly renewable term or *ART* annually renewable term) the premium would increase every year the contract is renewed for a new one-year period of coverage. Some companies impose an upper age limit, such as age seventy, on the renewability of term insurance. Because of the relatively short durations of coverage, these policies do not typically develop cash surrender values or have any policy loan availability.

.25 Most term insurance policies are convertible, that is, they can be converted to whole life or other cash value forms of life insurance that do not limit the upper age of renewability or coverage. Therefore, CPAs should consider comparing not only term insurance rates but also the rates and quality of the whole life policies into which the term insurance can be converted.

.26 There are also term insurance policies that do not include convertibility and renewability privileges. These coverages can neither be converted to another form of coverage nor renewed once they expire. CPAs should only consider using these policies in very special circumstances.

Summary of Term Insurance Features

Premiums:	Low initially, increasing annually, no flexibility
Cash value:	None
Investment vehicle:	N/A
Death benefits:	Guaranteed, fixed, no flexibility
Appropriate for:	1. Clients with heavy cash flow constraints 2. Clients with temporary needs

Variations - Types of Term Insurance

Group term:	Offered to employee groups and organizations. (Discussed in greater detail at ¶ 3/570.73.)
Level term:	Premiums remain constant for a fixed number of years. Death benefit remains constant.
Decreasing term:	Premiums are level for the life of the contract, but the death benefit gradually reduces.
Reentry term:	A type of term policy that requires a medical examination at certain intervals to keep the premiums at a low rate. If the insured has an impairment to his or her insurability, the premiums may move to a higher rate.

.27 Action Tips. The CPA should keep the following in mind when reviewing term policies:

- Be sure to look for the conversion feature.
- If the policy is convertible, make sure the insurer's permanent policies are competitive.
- Make sure to examine the difference between the low premiums and the high premiums under reentry contracts.
- Be careful when choosing reentry contracts; the criteria for reentry are established at the discretion of the insurance company.

.28 Whole Life Insurance. Whole life insurance is the traditional policy with level premium payments, which is designed to remain in force over the entire lifetime of the insured individual. Premium payments in the early years are deliberately higher than would be required to cover the probability of death alone. This excess charge in early years makes it possible for the policy to build cash values, which build with interest and are used to pay for the cost of insurance in years when the insured is older and more likely to die.

.29 The cash values that the whole life contract builds can be borrowed from the insurer or obtained by surrendering the policy. The interest rate charged on policy loans may be set forth in the life insurance contract as either a specific flat rate, such as 8 percent, or a fluctuating rate with limitations imposed by a specified index, such as Moody's average yield on seasoned corporate bonds.

.30 On ordinary whole life policies, the premiums are payable for the lifetime of the insured. Limited pay policies allow the premium to be paid over a shorter time period, such as ten years, twenty years, or to some specified age such as sixty-five. Since the premium paying period on limited pay policies is shorter, the amount of the yearly premium must be higher to build up an adequate reserve for future years.

.31 Whole life policies are designed to provide a lifetime of protection. The death benefit may be payable whenever the insured dies or may be payable before death because, for example, the full death benefit could be payable at age 100.

Summary of Whole Life Insurance Features

Premiums:	Level, guaranteed, limited flexibility.
Cash value:	Guaranteed, dividends can increase cash value.
Investment vehicle:	Primarily long-term bonds and mortgages.
Death benefits:	Guaranteed, no flexibility, dividends can increase death benefit.
Appropriate for:	1. Clients with long-term needs. 2. Clients not willing to assume risks traditionally held by the insurer. 3. Clients requiring guaranteed death benefits, cash values, or premiums.

Variations of Whole Life Insurance

Graded premium life:	Same as traditional whole life, except that premiums start out low, increase at fixed increments, and then level off for life. Cash values tend to be low, since premiums start out lower.
Endowment policies:	Same as traditional whole life, except that the policy matures at an earlier age to provide retirement income. The policy has, generally, not been available since 1986.
Interest-sensitive whole life:	Same as traditional whole life, except that cash values accumulate at a floating rate of interest.

.32 Action Tips. When examining whole life policies, the CPA should remember the following:

- Consider only those companies with a strong record.
- On interest-sensitive policies, do not rely solely on the nominal rate of interest when comparing two policies. Insurance companies can adjust this rate up or down depending on their charges for mortality costs and administrative expenses.
- On interest-sensitive policies, examine the company's history of interest rates actually paid on its policies.

.33 Universal Life Insurance. Universal life insurance is a type of cash value life insurance that can be quickly summed up as *flexible premium, flexible death benefit* life insurance.

Universal life contracts provide separate disclosures about expenses, mortality charges, and interest rates. In addition, they allow policyholders access to cash values either through policy loans or through direct withdrawals.

.34 The first year premium is the only required premium under a universal life policy. After the first policy year, the policy owner is free to raise, lower, or even skip the premium payments as desired, as long as there is enough cash value to keep the policy in force. The upper limit on premiums in universal life policies is established in the definition of life insurance set forth in IRC Section 7702. The lower limit on premiums is the cost of the term insurance that the policy must have to keep it in force.

.35 Policy owners can choose between two different death benefit designations for these policies. One designation, typically called *option A*, provides a death benefit equal to the face amount. The other death benefit designation, typically called *option B*, provides the policy cash value *plus* the face amount as the death benefit. Under either designation, the amount at risk is the difference between the death benefit payable and the cash value in the policy. The mortality charge is based on the amount at risk and the mortality rate for the attained age of the insured.

.36 The cash value of any universal life policy is explicitly increased by premium payments and monthly interest earnings, and decreased each month by mortality and expense charges. The interest rate credited to the cash value is a discretionary rate set by the insurance company, but is usually higher than the guaranteed rate. A lower interest rate is usually credited to that portion of the cash value equaling any outstanding policy loans.

Summary of Universal Life Insurance Features

Premiums:	Flexible, within limits, can be increased or decreased at option of policyholder
Cash value:	Limited guarantees, floating interest rate with guaranteed minimum rate
Investment vehicle:	Generally, intermediate-term fixed investments
Death benefits:	Flexible, not guaranteed
Appropriate for:	1. Clients with changing financial needs 2. Clients with long-term needs 3. Clients willing to give up guarantees in exchange for greater flexibility

.37 **Action Tips.** The following should be considered by the CPA when examining universal life policies:

- Many companies have more than one universal life contract. Make sure to see them all, because many have lower cost structures built into them.
- On interest-sensitive policies, do not compare the nominal rate of interest on two policies. Insurance companies can adjust this rate up or down depending on their charges for mortality costs and administrative expenses.

- Examine the company's history of interest rates on its policies and compare them to the company's rate of return on its portfolio.
- Check for policy charges associated with premium or death benefit changes and surrenders.
- Make sure the assumed interest rate is at a level that can realistically be expected to be paid over the life of the policy.

.38 **Variable Life Insurance.** Variable life insurance is similar to whole life insurance in that it has fixed premiums and a minimum guaranteed death benefit. The difference is that the investment risk and return are shifted to the policy owner. Much like selecting among mutual funds, the policy owner is able to direct the funds backing the policy into one or more of a group of segregated investment accounts made available by the life insurance company. Typically, the policy owner is able to allocate assets among a stock fund, a bond fund, and a money market fund. Because the policy owner picks the portfolio of investments, there is no minimum cash value guarantee.

.39 When the performance of the portfolio is good, both the cash value and the death benefit of a variable life policy increase proportionately. When the portfolio performance is below expectations, the death benefit may drop, but if premium payments are maintained, it will never drop below the original amount of coverage when the policy was issued.

.40 Variable life policies are particularly suitable for policy owners who desire to choose how the portfolio backing the life insurance policy is invested and are willing to assume the investment risk that goes with that responsibility. Consequently, these policies may not be appropriate for persons who become anxious over short-term fluctuations in stock and bond prices. Because most companies offer a short-term money market account option, policy owners generally can select a conservative investment strategy. However, even this strategy is riskier than traditional whole life policies because money market rates, theoretically and actually, can fall below minimum guaranteed rates on traditional policies.

.41 The allocation of the investment portion of the contract needs to be made within the client's overall investment strategy. See AICPA *Investment Planning Module* of the *PFP Manual*.

Summary of Variable Life Insurance Features

Premiums:	Fixed
Cash value:	Not guaranteed, policy owner has choice of investment options such as stocks, bonds, money markets or guaranteed rates
Investment vehicle:	A managed pool of money for each investment choice within the contract
Death benefits:	Minimum guaranteed level, death benefits in excess of the minimum are subject to the investment performance
Appropriate for:	1. Clients who want more investment flexibility 2. Clients with long-term needs

3. Clients willing to give up some death benefits and cash value guarantees in exchange for potentially higher death benefits and cash values

.42 Action Tips. When reviewing variable life policies, the CPA should keep the following in mind:

- Look for an insurer with a strong historical performance for its managed accounts. Managers of popular mutual funds also manage accounts for variable life policies.
- Compare the policy fees and management fees of several companies.
- Make sure that the client fully understands the investment risks associated with the investment choices.

.43 Variable Universal Life Insurance. Variable universal life insurance is a hybrid of universal life and variable life insurance. It lets policy owners adjust premiums and reconfigure the death benefit. The cost of this increased flexibility, however, is the performance of the equities invested. As in the variable life contract, the policy owner gets to choose the investment medium under this contract, and there are no guaranteed cash value levels or growth.

.44 Policy owners are given the choice of option A death benefits (face amount only) or option B death benefits (face amount plus cash value).

Summary of Variable Universal Life Insurance Features

Premiums:	Flexible, not guaranteed
Cash value:	Not guaranteed, policy owner has choice of investment options, such as stocks, bonds, money markets, or guaranteed rates
Investment vehicle:	A managed pool of money for each investment choice within the contract
Death benefits:	Flexible, not guaranteed
Appropriate for:	1. Clients with changing financial needs 2. Clients with long-term needs 3. Clients willing to give up guarantees in exchange for policy and investment flexibility

.45 Action Tips. CPAs should remember the following when reviewing variable universal life policies:

- Look for an insurer with a strong historical performance for its managed accounts. The managers of popular mutual funds also manage accounts for variable life policies.
- Compare the policy fees, surrender charges, and management fees of several companies.
- Make sure that the clients fully understand the investment risks associated with their investment choices.

.46 Single Premium Whole Life Insurance. Single premium whole life insurance has only one premium payable under the contract, with the initial cash value usually equaling the premium. The death benefit under this type of policy is usually lower than other types of permanent insurance. Because the emphasis is on growth of cash values rather than on death benefits, the cash value grows at a floating rate, just as under universal life and interest-sensitive whole life policies. If the policy terminates in a death claim, the cash-value buildup escapes income taxation. In any case, the cash-value buildup enjoys tax deferral until the policy is terminated either by death or surrender prior to a death claim.

.47 These policies can provide a respectable return to policy owners even after mortality charges and other expenses. However, single premium whole life policies may be subject to significant surrender charges in the early years of the contract. If the policy is surrendered for cash while the surrender charges are applicable, they can reduce the investment performance. These policies are not strictly an investment and should not be considered for purchase solely for investment purposes.

.48 Since 1988 changes to the tax law, no deductions are allowed for policy loan interest on single premium whole life policies.

For a discussion, of the tax implications see the section on modified endowment contracts below at ¶ 3/560.109.

Summary of Single Premium Whole Life Insurance Features

Premiums:	One premium payment
Cash value:	Accumulates at a floating interest rate
Investment vehicle:	Intermediate-term fixed and variable rate investments
Death benefits:	Minimum guaranteed, increases over time according to cash value buildup
Appropriate for:	Clients who are past age fifty-nine and one-half seeking tax deferred accumulation and tax-free death benefits

Variation of Single Premium Whole Life Insurance Features

Single premium variable life:	Same as single premium whole life except that the cash values can be invested in common stocks, bonds, money markets, and the like

.49 Survivorship (Second to Die) Life Insurance. A variation of whole life that covers more than one life, but only pays a death benefit on the last death. Because the death benefit is paid only once and only after *all* insureds have died, the premium burden for a survivorship policy is significantly lower than that for two or more separate policies. This type of policy has increased in popularity as a result of the unlimited marital deduction, which permits married couples with large estates to defer estate tax liabilities until the second death.

Summary of Survivorship Life Insurance Features

Premiums:	Lower than a single-life policy
Cash value:	Guaranteed; dividends can increase cash values
Investment vehicle:	Long-term bonds and mortgages
Death benefits:	Guaranteed; dividends can increase death benefits
Appropriate for:	Married clients with taxable estates in excess of $1.2 million who wish to purchase term, whole life, or universal life insurance to offset the impact of estate taxes

.50 **Action Tips.** The following should be considered when a CPA reviews a survivorship life insurance policy:

- Investigate what happens to internal mortality expenses after the first death. Some companies substantially increase these costs after the first death.
- Consider that a client with a healthy spouse, who is unable to purchase a one-life insurance policy because of insurability problems, can often purchase a survivorship policy.
- If the client purchases a policy through an irrevocable life insurance trust, the cash values may not provide a living benefit to the settlor/insured. Consideration should be given to a lower premium structure that does not generate substantial cash values.
- Remember that in the event of a divorce, the policy may be split into two separate single-life policies with a new premium structure.
- Be careful of large amounts of term insurance built into survivorship policies. If dividends do not meet projections, the policy could require substantial premiums down the road.

Key Life Insurance Terms

.51 The following are some of the key terms associated with life insurance contracts.

.52 **Accidental Death Benefit.** An additional benefit available as a rider under most policies that pays an amount equal to a multiple of the stated death benefit provided the insured dies as a result of an accident. To qualify, death must usually occur within ninety days of the accident. The CPA should not include accidental death benefits for planning purposes.

.53 **Automatic Premium Loan.** A provision in whole life policies that permits the insurance company to use the policy loan provisions to make premium payments when the insured fails to pay the premium due within the grace period. In addition, any interest due the insurance company as a result of policy loans can be taken out in the form of an additional policy loan.

.54 **Contestibility Period.** A contestibility period provides assurance to the policy owner that the validity of the contract and the statements made in the application by the policy owner cannot be questioned after the fixed contestibility period (usually two years) has elapsed.

.55 **Conversion.** An option available under many term insurance policies that permits the insured to convert the term insurance policy into a permanent policy without providing proof of insurability.

.56 **Dividends.** Amounts paid under *participating* policies that reflect premium payments, expenses, earnings, favorable mortality experience, and profits. Dividends are often projected for both new and existing policies, but no dividends are ever guaranteed by an insurance company. Because dividends represent a return of premium, they are not taxable as income to the policy owner. See discussion at ¶ 3/560.85.

.57 **Freelook.** A period of time, generally ten days from delivery (receipt of policy), during which policy owners can examine the policy to determine whether they wish to keep it or return it for a full premium refund.

.58 **Grace Period.** A period of time after the premium due date (usually thirty days), during which the policy owner can pay the premium without the risk of lapse. If the insured dies during the grace period, the face amount of the policy will generally be paid minus any unpaid premiums.

.59 **Guaranteed Insurability Option.** An additional benefit available under many policies that permits the insured to purchase additional amounts of insurance at stated intervals without providing proof of insurability.

.60 **Nonforfeiture Options.** A privilege allowed under terms of the contract after cash values have been created. See discussion at ¶ 3/560.84.

.61 **Participating/Nonparticipating.** Participating policies pay annual dividends to the policyholder based on premium payments, expenses, mortality experience, and profits. Dividends are often projected for both new and existing policies, but no dividends are ever guaranteed by an insurance company. Nonparticipating policies pay out any profits to the company stockholders, not to the policy owners.

.62 **Policy Basis.** An amount equal to the premiums paid less policy owner dividends and any other amounts previously withdrawn.

.63 **Policy Loan.** The policy owner may, at any time, take a loan from an insurance policy equal to an amount not greater than the policy's cash surrender value. The loan may bear interest, at either a fixed or variable rate as stipulated in the policy. Any loans not repaid at the time of death or surrender of the policy generally are subtracted from the death benefit or cash value payable to the beneficiary or owner. Consideration should be given to the policy loan rate versus cash surrender value market rates of interest. (See discussion at ¶ 3/560.109.)

.64 **Reinstatement.** Most permanent life insurance policies allow a policy to be reinstated during a period of time (usually five years) after a default of premiums. Requirements of reinstatement are usually proof of insurability, payment of all past due premiums with interest, and the repayment and or reinstatement of any policy indebtedness existing at the date of premium default, with interest.

.65 **Renewability.** A provision found in term insurance policies that guarantees the right of the insured to renew the policy at the end of the policy period without providing evidence of insurability. To prevent adverse selection, insurance companies can limit the age at which the insured can automatically renew the policy.

.66 **Right to Change Beneficiary.** Policy owners may change a beneficiary as often as they like, unless an irrevocable beneficiary was named.

.67 **Settlement Options.** The methods by which the beneficiary or the insured can have life insurance proceeds paid. (See discussion at ¶ 3/560.75.)

.68 **Split Dollar.** A method of sharing premium payment, cash value, death benefits, and dividends. It is often used in situations in which the insured party (for example, an employee) pays a portion of the premium and the other party (for example, an employer) pays the balance of the premium.

.69 **Substandard (Rated) Cases.** The charging of a premium rate that is higher than that charged for a standard risk because of the greater risk (usually related to the health or occupation of the insured) undertaken by the insurance company.

.70 **Suicide Clause.** If the insured commits suicide within a period of time stipulated in the contract (usually two years), the insurance company is not required to pay the face amount. After the expiration of that stipulated period, suicide is treated as any other form of death.

.71 **Surrender Charges.** A stipulated dollar amount or percentage of accumulated cash value that may be deducted from the accumulated cash value upon surrender of the contract. It is often a declining percentage over a ten- to twenty-year period. Policy loans can never exceed the accumulated cash values minus any applicable surrender charges.

.72 **Vanishing Premiums.** A marketing concept allowing future premiums to be paid through policy earnings. CPAs should consider stressing to clients that there are no guarantees that future policy earnings will be sufficient to cover future premiums.

.73 **Waiver of Premium.** An additional benefit available as a rider under most policies that provides for the continuation of premium payments by the insurance company if the insured becomes totally and permanently disabled.

.74 **War Clause.** During times of war, insurance companies may include a clause in their contracts stating that death benefits will not be paid on deaths resulting from an act of war, with a return of premiums paid with interest. This clause is, generally, not part of contracts issued during peacetime. The purpose of this clause is not to reduce the insurer's liability as a result of war-related deaths but, rather, to prevent adverse selection during times of war.

Settlement Options

.75 Life insurance benefits are generally paid on the death of the insured: death benefits, or at some other time during the insured's life that is specified in the policy: living benefits. Although most life insurance death benefits are paid in a lump sum, the insurance companies offer several alternative methods of payment. The most common settlement options available are listed below.

.76 **Interest Only.** The policy proceeds may be left with the insurance company, with only the interest earnings from this amount paid to the beneficiaries. The interest paid is usually higher than the guaranteed rate.

.77 **Installments of a Fixed Amount.** Policy proceeds (principal) and interest may be paid to the beneficiary in a fixed amount for as long as the principal and interest on the remaining (unpaid) portion of the principal last.

.78 **Installments for a Fixed Period.** Policy proceeds and interest may be paid to the beneficiary in regular installments over a fixed period of time. The payments do not continue beyond that period of time.

.79 **Life Income with Refund.** Benefits are paid over the life expectancy of the primary beneficiary, but in the event the beneficiary dies prior to receiving an amount equal to the policy proceeds, the difference is paid to a contingent beneficiary either through a cash refund or installment refund.

.80 The cash refund enables a contingent beneficiary to receive a lump-sum payment from the company, whereas the installment method allows for payments to continue to the contingent beneficiary until the proceeds are exhausted.

.81 Life Income with Period Certain. A fixed benefit is paid for the life of the primary beneficiary with a minimum number of payments, the *period certain*, guaranteed to be made. If the beneficiary dies prior to the receipt of the minimum number of payments, the remaining payments required to be made are paid to a contingent beneficiary for the balance of the period.

.82 Joint and Survivor Life Income. Benefit payments are made to two payees as long as both or either of the beneficiaries are alive. A possible modification of this plan provides that the amount of the benefit could decrease when the first of the two payees dies.

.83 Straight Life Income. Benefits are paid out in equal installments over the lifetime of the primary beneficiary. The beneficiary is entitled to this amount during his or her entire lifetime. At the death of the beneficiary, the payments may cease.

.84 Nonforfeiture Options. If the policy owner of a permanent policy fails to pay the premiums due within the grace period or decides not to pay further premiums and does not wish to surrender the contract, there are three living-benefits options available under most policies.

- The policy owner can elect to receive the cash surrender value on termination of the insurance contract. In the alternative, the policy owner could borrow the cash surrender value from the contract at any time. Policy loans are considered an advance on the death benefits and need not be repaid. Unless repaid, the loan will be deducted from any death benefits payable. Insurance companies have the right to delay payment of the cash surrender value for a period of up to six months, although very few of them exercise this option.
- The policy owner can elect to receive a reduced amount of paid-up insurance that is of the same kind as the original policy, subject to the terms and conditions of the original policy. The paid-up policy may require no additional premium payments. The paid-up policy is computed as a single premium policy at the attained-age rate. This option may have its greatest attraction for older insureds who no longer have a substantial need for life insurance protection.
- The policy owner can elect to have the policy continue as pure term insurance for the period the built-in values in the policy would cover based on the attained age of the insured. The disadvantage of this is that mortality rates are much greater than if the policy continued as originally intended.

.85 Dividend Options. Dividends represent a *return of excess premiums*. Therefore, they are not taxable to the policy owner. For participating policies, policy owners can apply the dividends as follows:

- Receive cash dividends after the company declares an annual dividend on the policy anniversary.

- Apply the dividends against the premiums of their policies when the premiums become due, instead of receiving them in cash.
- Leave the dividends at interest with the company, which the policy owner can withdraw at any time. Interest at some guaranteed rate may be paid on the deposit, and the insured may also share in the company's excess interest earnings. Interest paid on accumulated dividends is taxable whether or not they are received by the policy owner.
- Use the dividends accrued to purchase an additional amount of paid-up permanent insurance. The amount of the additional insurance is based on the attained age of the insured.
- Use the dividends to continue the policies in force as term insurance for as long as the cash values permit. The cash value is used to make a net single premium purchase in the face amount of the policy with the nonforfeiture value. If the insured does not request another option, the company normally provides extended term insurance.

Replacement of Existing Life Insurance Policies

.86 Because a person's financial needs change over the course of a lifetime, older life insurance policies may no longer match the client's needs. When reviewing a portfolio of insurance policies, the CPA should consider whether the older policies represent an efficient use of the client's insurance dollars compared with the newer policies being issued. When considering the replacement of an older life insurance contract with a new policy, there are many issues that must be reviewed.

.87 Retaining an Insurance Policy. In many instances, it may be in the client's best interest *not* to replace the old insurance, because existing contracts can often be modified to meet the client's needs. The CPA should consider the following:

- The insured may have to meet a new suicide and contestability period.
- The old policy may have built up a substantial annual dividend, which the new policy may not be able to equal.
- Under older participating policies, there is often a substantial amount of flexibility in how dividends are paid and accumulated. Quite often, a simple change in the use of a dividend can make the policy meet the client's objectives.
- The policy owner may have new surrender charges to deal with. In many instances, if the client surrenders the new policy within the first few days, the client may have to pay heavy surrender charges.
- IRC Section 2035 (transfers within three years of death) may apply to the new policy.
- The insured may not be insurable at standard rates.
- Many older policies have more generous annuity tables than do newer policies.
- Policies issued on or before June 20, 1988, benefit from grandfather protection from the restrictive provisions governing the taxation of Modified Endowment Contracts (MECs).
- The new policy may be subject to new commission and acquisition charges.

.88 Replacing an Insurance Policy. In some cases, the features of an older policy suggest that replacement is the wiser course to follow. Consideration should be given to the following:

A. The underwriting company's *quality* ratings may have declined substantially since the policy was originally written. A change in companies could be prudent.
B. The internal rate of return on the existing policy after all modifications have been made could be substantially lower than that available under new policies. Many older nonparticipating whole life policies fall into this category.
C. If the client has many small policies, one large policy may be administratively less expensive and more convenient to maintain.
D. Before an existing policy is replaced, a projection of that policy's future benefits should be considered based on the company's then current dividend scale. Many policies with 5 or 6 percent loan provisions have introduced substantially higher dividend scales in exchange for a variable loan rate. It is important to illustrate the most favorable dividend scale because many new policies issued in 1991 are with variable loan rates, not the low fixed rates of years ago.
E. When comparing two policies, it is very important to consider the company's history of dividend payments and interest rates. Look for companies that in the past have maintained a steady interest rate and have met or exceeded projections in their dividend payments.
F. If the client has an older universal life policy that is being considered for replacement, it is important to look first at changes that might have to be made. Under a universal life policy, the premiums and death benefits can be adjusted up or down to meet the client's objectives.

.89 When replacing any insurance, it is important to look at the impact of IRC Section 1035 which allows the tax-free exchange of one insurance policy for another. The tax basis of the existing policy is rolled over into the new policy. Under IRC Section 1035, a life insurance policy can be exchanged for either another life insurance policy or an annuity without current tax consequences. An annuity contract, however, can only be exchanged for another annuity contract.

Low-Load and No-Load Life Insurance

.90 During the past several years, consumer awareness about commissions paid under various financial products, such as stocks and bonds, mutual funds, and life insurance, has increased. As a result, several companies are now offering commission-free insurance products that are marketed directly to the prospective insurance purchaser by the insurance company. However, all policies, even so-called no-load policies, have marketing and administration expenses and profit margins.

.91 The CPA should be aware of these policies and should recognize the potential cost savings in the policies. Although the premium costs may be lower under these policies, remember that in many instances an insurance professional expends a substantial amount of effort and time in selecting the appropriate policy and in working with the client until the policy is issued. The CPA should consider informing the client to weigh the premium cost savings of a no-load life insurance product by the increased amount of the CPA's time cost, possibly resulting in no net savings to the client or an additional cost to the client.

Calculating Internal Rates of Return on Permanent Life Insurance Policies

.92 Given the appropriate information, calculating the rate of return on a life insurance policy is relatively easy. Use the following formula to calculate a client's annual yield on an existing permanent life insurance policy. This formula is useful in analyzing alternative uses for the cash surrender values of the policy.

Note: This calculation yields results for the current year only.

$$AY = \frac{(ECV + D) - (P + BCV - I)}{(P + BCV - I)}$$

ECV	=	Ending cash value
BCV	=	Beginning cash value
D	=	Dividend
P	=	Premium
I	=	Cost of insurance benefit
AY	=	Annual yield

.93 When calculating the cost of the insurance benefit, the CPA calculates the cost per thousand dollars of the cheapest term insurance available to the client. This cost per thousand dollars is then applied to the net death benefit under the contract, which is the face value minus the beginning cash value. If the client wishes to determine the yield on the policy without factoring in the relative cost of the life insurance benefit, simply delete the cost of insurance benefit (I) from the formula.

.94 For example, a policy had a cash value of $10,000 on January 1, 19X1 and a cash value of $14,500 on January 1, 19X2. During the year, a premium of $7,000 was paid, and a $2,000 dividend was received. The estimated cost of the insurance benefit protection during the year was $1,500.

$$\frac{(\$14{,}500 + \$2{,}000) - (\$7{,}000 + \$10{,}000 - \$1{,}500)}{(\$7{,}000 + \$10{,}000 - \$1{,}500)} = 6.45\%$$

Filing for Claims

.95 When a death occurs, the agent and the insurance company must be notified immediately in writing. The insurance company may provide a form to complete, which must be returned with a certified copy of the death certificate and the policy itself. The policy owner may receive the payment check within two months, but in many instances the proceeds are paid within days of satisfying the requirements.

.96 If death occurs within the contestability period, the process may take longer because the policy can still be contested by the insurance company. If death is due to illness, the company would want to make sure that all the questions on the application were answered truthfully. In this case, the process can take several months or more.

Creditor's Rights

.97 In most states, the proceeds of life insurance policies are exempt from the claims of the deceased creditors. The laws vary from state to state, and in some states the proceeds are also exempt from the claims of the beneficiary's creditors. The CPA should consider determining, with the assistance of legal counsel, what the law is in the insured's state of residence.

.98 The rules also vary from state to state for the claims of creditors against cash values accumulated in a life insurance or annuity contract. The CPA should check the law in effect in the client's state of residence to determine the relative measure of protection from claims of creditors.

Income Tax Implications

.99 **Premiums.** With the exception of the employer's deduction for the first $50,000 of employer-provided group term life insurance, no deduction is permitted for premium payments at either the corporate or individual level on life insurance policies.

.100 **Dividends.** To the extent that dividends received by the policy owner do not exceed the policy owner's basis in the policy, they are generally not subject to federal income taxation. If the dividends received by the policy owner exceed the basis in the policy, they may be taxable. (See additional discussion of modified endowment contract policies at ¶ 3/560.109 below.)

.101 **Cash Values.** The buildup of cash value in a life insurance policy is not taxable income as long as the policy remains in force. In addition, the cash value buildup in a life insurance policy is exempt from income tax if the policy terminates in a death claim. However, if the policy is surrendered for cash, the gain on the policy is subject to federal income taxation. (See additional discussion on modified endowment contract policies at ¶ 3/560.109 below.) The gain on a surrendered policy is the excess of the net cash value payable and policy loan forgiveness over the owner's basis in the policy. Basis in the policy equals the premiums paid less policy dividends and less any other amounts previously withdrawn.

.102 Policy Loan Interest. Starting on January 1, 1991, policy loan interest is not deductible. Prior to January 1, 1991, the interest paid on policy loans was subject to tracing rules and, unless it otherwise qualified, the interest paid on a policy loan was consumer interest subject to the personal interest deduction limitations.

.103 Interest paid on policy loans used for investment purposes is classified as investment interest expense and is deductible to the extent of investment income. If interest expense exceeds investment income in one year, the excess may be carried forward and deducted on future tax returns. Similarly, if the loan proceeds were used for business purposes, the interest is deductible business interest.

.104 On business life insurance policies covering officers, employees, or anyone financially interested in the business, no deduction is allowed for interest on the portion of the aggregate amount of policy loans in excess of $50,000 per individual unless the policy was purchased before June 20, 1986. If certain requirements are met, interest paid on loans against those older policies may be entitled to a full interest deduction.

.105 Death Benefits. The death benefits payable under a life insurance policy are generally free from federal income taxation. Proceeds from corporate-owned life insurance policies may be taxed under the corporate *alternative minimum tax* (AMT). Roughly, the tax is 15 percent of the difference between the total death benefit and the policy cash value at the time of death.

.106 Life insurance policies that have been transferred from one policy owner to another may be subject to the transfer for value rule. Under this rule, the death proceeds of a policy transferred for a valuable consideration are taxed as income to the extent the death proceeds are greater than the purchase price plus premiums paid by the transferee. Thus, if an existing life insurance policy or an interest in an existing policy is transferred for any type of consideration in money or money's worth, all or a significant portion of the death benefit proceeds may lose its income tax-free status.

.107 Policies can be transferred safely to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer, without subjecting the proceeds to income tax, even if the transfer is for a valuable consideration.

.108 Corporate-owned life insurance payable to a shareholder beneficiary may be taxed as a dividend.

Modified Endowment Contracts (MECs)

.109 Distributions, such as cash withdrawals or policy loans, from a life insurance policy classified as a modified endowment contract (MEC) may be taxed differently from the above discussion of non-MECs. The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) created a new classification of life insurance policies: MECs. If a policy is a

MEC by failing the seven-pay test, distributions from the policy may be taxed less favorably than if the seven-pay test is met.

.110 A policy fails the seven-pay test if the cumulative amount paid at any time during the first seven years of the contract exceeds the net level premiums that would have been paid during any of the first seven years if the contract provided for paid-up future benefits. If a material change in the policy's benefits occurs, a new seven-year period for testing must begin.

.111 Distributions, including policy loans, cash dividends, and partial withdrawals from MECs are taxed as income at the time received to the extent that the cash value of the contract immediately before the payment exceeds the investment in the contract. This means that policy distributions are taxed as income first and recovery of basis second. Additionally, there is a penalty tax of 10 percent on distribution amounts included in income unless the taxpayer has become disabled, has reached age fifty-nine and one-half, or the distribution is part of a series of substantially equal payments made over the taxpayer's life.

.112 For the purpose of determining the amount includable in gross income, all policies issued by the same company to the same policyholder within any twelve-month period are treated as one MEC under IRC Section 72(e)(11).

.113 With some exceptions, life insurance policies issued on or before June 21, 1988, are grandfathered and are not required to comply with the seven-pay test.

Estate Tax Implications

.114 The proceeds of a life insurance policy may be included in the estate of the insured for federal estate tax purposes if the insured held any *incident of ownership* at any time during the three years prior to death or the proceeds from the policy were payable to or for the benefit of the estate of the insured. Incidents of ownership include the right to change the beneficiary, take out a policy loan, or surrender the policy for cash.

3/565 LIFE INSURANCE STRATEGIES

Understanding the Problem

.01 Life insurance achieves its primary function of providing for the health, welfare, and maintenance of the beneficiaries on the death of the insured by creating a pool of capital that can, in turn, be used by the client's beneficiaries to solve any ensuing personal and business problems.

.02 To understand how life insurance can be used and to appreciate how the CPA's imagination and creativity are the only major boundaries limiting the scope of life insurance's uses, the CPA must first focus on the problems. The CPA must match the products with the problems to be solved in the priority order that the client assigns to those problems. The CPA may want to include life insurance professionals, such as a Chartered Life Underwriter (CLU), as players on the team.

.03 The client's family may face the following major problems:

- *Lack of liquidity*. Following a client's death, there may not be enough cash to pay death taxes, administrative costs, attorneys' fees, appraisal fees, and other death-generated expenses as they fall due. This is one of the major and more obvious reasons for life insurance.
- *Improper disposition of assets*. Many times the awesome responsibility of safeguarding, investing, and distributing the income from an extensive estate or the task of running a business interest is thrust upon persons who are unable or unwilling to handle it. The wrong asset goes to the wrong person at the wrong time in the wrong manner. Life insurance is often used as a substitute for property. That is, life insurance proceeds might be paid to or owned by a trust for the benefit of a beneficiary who cannot or should not consider managing a complex portfolio or running a business, while the more competent, capable, and willing beneficiaries might be left securities or a business interest.
- *Inadequate amounts of income or capital*. At the client's death, disability, or retirement, income or capital for normal living expenses or for special needs is often insufficient. For example, college costs continue to climb. This in turn exhausts funds that might otherwise have been used for retirement and leaves many facing retirement with debts rather than assets. Also, clients are living longer, have greater medical expenses during retirement, and, surprisingly, higher (rather than, as expected, lower) standards of living and maintenance costs. In many cases, they have more leisure time to travel, to try new hobbies, and to spend money than they did before they retired, whereas fewer of their after-retirement expenses are paid for by earnings. Cash-value life and disability insurance are obvious parts of the answer to these problems provided the protection is coordinated with other investment planning.
- *Unstabilized or nonmaximized value of the client's assets (particularly real estate portfolios or business interests)*. When all or the bulk of an estate consists of real estate, the cash required to pay taxes often far outstrips the cash available to pay those taxes. The result could be a forced sale of the real estate at the worst possible time. Likewise, a business that loses a key employee through death (or disability) often loses value needlessly. Without a buy-sell agreement, the client's family rarely obtains a full and fair price for the business interest. The absence of a buy-sell agreement between business owners results in a total lack of a market for the business interest or at best a forced sale at pennies on the dollar. Life and disability income insurance have been the traditional shock absorbers used to stabilize a business at a key employee's death or to buy out and bail out the heirs of a shareholder-employee.
- *Excessive transfer costs*. The cost of transferring wealth from one generation to another continues to increase because of increasing federal and state taxes, probate costs, attorneys' fees, and other slippage. When property is owned in more than one state, ancillary administration (multiple probates) results in unexpected

aggravation, delay, and expense. In many cases the ownership of property is set up in a manner that aggravates rather than minimizes the tax burden and other costs. Life insurance can be used to avoid or alleviate all of these problems.

- *Special needs.* Successful clients often express a strong desire to *give something back* to their schools, churches or synagogues, communities, or charitable organizations. Many clients have spouses or children with certain gifts or disabilities that require larger than usual amounts of both capital and income or who have asset management needs that would not be served by having them receive the property outright. Life insurance is often the most effective means and sometimes the only way of raising large amounts of cash to create financial security for an individual or to provide for the desired contribution.

.04 Only after the CPA has identified the needs and the client has expressed a preference about the order of the needs should the CPA consider attempting to formulate an insurance strategy. Few clients can solve all their financial problems simultaneously. Resources must, therefore, be allocated to the tools or techniques that are most cost effective in solving these problems.

Examining the Viable Alternatives

.05 Life insurance is a unique product in that a premium payment can guarantee and generate a vastly disproportionate amount of capital and make that capital available almost instantly. The need for large amounts of capital in the event of a death can be satisfied through life insurance.

.06 Clearly, life insurance is one of the most important of all the wealth creation and wealth transfer tools. Yet, the CPA should never consider choosing *any* tool without asking, "What are the no-cost or less costly alternatives to this tool that could also solve the client's problem, and what are the pros and cons of each?"

.07 Once the advantages and disadvantages of the viable alternatives are examined, the CPA can objectively ascertain which course or courses of action may result in the highest present value of capital and income for the family unit as a whole and which course or courses of action may result in the lowest present value in terms of financial and other costs. In many cases life insurance may be the indicated tool. How that life insurance is arranged makes a considerable difference in the tax implications and ultimate cost effectiveness.

An Insurance Planning Checklist

.08 Decisions in financial, estate, business, and employee benefit planning for life insurance (or any other tool or technique) must not be made in a vacuum. A CPA may be held accountable both for what is said and done and for the advice that he or she should have considered giving. Therefore, before any strategy is suggested and implement ed regarding life insurance, the CPA should consider the implications of the following:

- Federal estate tax, gift tax, income tax, generation-skipping transfer tax, and alternative minimum tax (AMT) at both the corporate and individual levels,
- The federal laws other than tax law, such as the securities laws and Employee Retirement Income Securities Act (ERISA).
- The state laws, including tax law that may track closely to or vary widely from federal law, which are often quite different from state to state.
- The client's cash flow strength. If the client cannot meet the cash flow demands of the product or technique suggested, it could fail regardless of how well it would seem to work on paper or in the long run.
- The client's psychological condition. The client's perception of a potential for:

  — A loss of legal control. If the CPA's recommendation results in the client's perceived or real loss of control, the end result may not be satisfactory for either party. Conversely, if the plan suggested results in strengthening legal control for the client, all parties could benefit.
  — A decrease in flexibility. Any situation that cannot be changed or can be changed only at great cost must be carefully considered regardless of the potential tax advantages. If the CPA's suggestion helps the client increase flexibility and adds options, the net gain could benefit both the client and the CPA.
  — An increase in aggravation. Tools that require high risk of audit, significant and constant paperwork, or a disproportionate degree of uncertainty and worry may be resisted by the client.

- The creditor's claims. Some tools, such as life insurance in most states, provide significant additional protection from the claims of creditors, whereas others provide none. Protecting assets against creditors' claims is a prudent adjunct to any financial plan.
- Conflicts of interest and other moral or ethical issues. Unfortunately, sometimes the selected choice of course of action involves using the tools with which the CPA is most comfortable. This, of course, is not always the way it should be. It is the client's comfort, benefit, and cost that should be utmost in the CPA's mind. This seems both clear and relatively easy to grasp. Yet, it frequently is not.

  — The CPA who has little knowledge of a tool should take the time to learn more about it, and to mention its possible uses to the client. The CPA who wants to enhance the client's opinion of him or her cannot reject a tool without thoroughly investigating it. The CPA who has a personal bias against a particular solution should still be objective to create the best possible plan for the client.
  — Some conflicts of interest or ethical issues are not so obvious. What course of action should be considered when a client wants to borrow policy cash values without a spouse's knowledge? What is the CPA's obligation when a spouse wants to change the beneficiary on a policy to the spouse's children rather than the children of the marriage?

Life Insurance as a Problem-Solving Tool

.09 Only when the thought process described above in the checklist has been used can the CPA consider recommending a particular strategy.

.10 Assuming that life insurance is the best vehicle for the job of solving one or more of these client problems and it has been ascertained that it can be used in a cost-efficient manner, the CPA tries to determine which specific life insurance ownership and beneficiary strategy would best meet the client's objectives. There are typically three variations of life insurance ownership: business, personal, and third-party.

.11 The following discussion focuses on those three types of ownership and illustrates how each strategy might be implemented, explains the strategy's advantages and disadvantages, covers the tax ramifications of the strategy, and lists situations in which the CPA should consider implementing the strategy.

3/570 BUSINESS-RELATED STRATEGIES

Introduction

.01 There are seven major ways businesses use life insurance:

A. Key-employee insurance
B. Death-benefit-only (DBO) plans
C. Buy-sell agreements
D. Split-dollar life insurance
E. Executive bonus (IRC Section 162) plans
F. Nonqualified deferred compensation plans
G. Group life insurance

Key-Employee Life Insurance

.02 General Considerations. Key-employee insurance is a life insurance policy owned by a business on the life or lives of employees (or outsiders) whose deaths could cause a significant economic loss to the business because the business depends on their skills, talents, experience, and business contacts that the business would find it difficult to replace.

.03 Although the loss of a key employee can negatively affect publicly held businesses, it is critical for closely held businesses. Their profits often depend on the ability, initiative, or judgment of a single individual or small group of persons, often including the owner/employees.

.04 If the need is short term, term insurance is indicated. However, in most cases the value of the truly key employee to a business increases over time. Often, key-employee coverage may be used for a long-term need, such as funding a buy-sell agreement with an indeterminate time span. Therefore, in this type of situation, the preferred coverage is almost always some form of permanent (cash-value) insurance.

.05 Generally, an employer-corporation owns the key-employee insurance and is also responsible for paying any premiums. As noted below under the discussion of taxation, there could be important tax consequences when the proceeds of an employer-owned policy are paid to a party other than the corporation or its creditors. To prevent this, a resolution should be entered into the corporate minutes mandating that the coverage has been purchased to indemnify the business for potential loss at the death of a key person and to serve any other corporate purpose.

.06 There is no universally recognized and accepted formula for computing the economic cost of replacing a key person or estimating with certainty lost profits or credit. Any discount factor used is at best an estimation. It should be established after a review of the surrounding facts and circumstances and in consultation with the business's advisers.

.07 Some questions that should be considered when determining the discount factor or range of discount include the following:

- How much would it cost to locate and situate a replacement? Will the new employee demand more salary? How much would it cost to train the replacement?
- What mistakes is a replacement likely to make during the break-in period? How much would those mistakes cost the company?
- How long would it take for a new person to reach the efficiency of the key individual?
- What proportion of the firm's current net profits are attributable to the key employee?
- Is the employee engaged in any projects that, if left unfinished at death or disability, would prove costly to the business? How costly? Would a potentially profitable project have to be abandoned or curtailed? Would a productive department have to be closed? Are there potential penalties or liabilities for the late completion of a project?
- Would the employee's death or disability result in the loss of clientele or personnel attracted to the business because of his or her personality, social contacts, unique skills, talents, or managerial ability?
- What effect would the key employee's death (or long-term disability) have on the firm's credit standing?
- What proportion, if any, of the firm's potential loss from the employee's death or disability is it willing to self-insure?

.08 The following computer printout illustrates the value of a key employee to a business using various discount assumptions over and under 20 percent.

*Key-Employee Valuation**

Input: Fair Market Value — With Key Employee	$750,000
Input: Discount Percent Without Key Employee	0.200

Discount Percent	Value w/o Key Employee	Value of Key Employee
0.160	$630,000	$120,000
0.170	$622,500	$127,500
0.180	$615,000	$135,000
0.190	$607,500	$142,500
0.200	$600,000	$150,000
0.210	$592,500	$157,500
0.220	$585,000	$165,000
0.230	$577,500	$172,500
0.240	$570,000	$180,000

* Produced by Number Cruncher Software and used with permission of Financial Data Corporation

.09 A sophisticated approach to valuing a key person's contribution to a business's profits is to estimate the number of his or her remaining working years and the annual loss of earnings attributable to that person per year, and then compute the present value of that annual loss using a reasonable discount rate. For example, assume an employee is expected to work another five years, and the company would expect to lose $30,000 a year because of the loss of this key employee. Assuming a 10 percent discount rate, the present value of the key employee's services would be about $113,000.

.10 Another method employs a *goodwill* valuation of the business and assumes that the increment over the reasonable return produced by capital should be considered attributable to management. This total would then be apportioned among the key employees by relative salaries.

.11 For example, a firm has an average annual asset value of $4,500,000 and an average annual earnings after taxes of $750,000. If 10 percent were considered to be a fair rate of return on tangibles, then $450,000 ($4,500,000 × .10) of the $750,000 would be attributable to tangibles. The remaining $300,000 ($750,000 — $450,000) would be attributable to goodwill. Further, 60 percent of this, $180,000, could reasonably be allocated to the efforts of management. If it takes five years to replace the entire management team, then the $180,000 to be produced (over and above the expected results of pure capital) by management is multiplied by five to arrive at a total of $900,000. If the key executive in question drew 80 percent of the total salaries of the management team, then that person's estimated worth to the business would be approximately $720,000 ($900,000 × .80). The disadvantage of this approach is that it does not consider the time value of money.

.12 Perhaps the simplest method of all is to multiply the key person's salary by a factor ranging from three to five. Although that sounds quite unscientific, to the extent salary is a measure of perceived worth, the approach has some validity. Future salary payments for a given number of years in the future could also be discounted to present value using some reasonable discount rate.

.13 Estimating the worth of a given employee and, therefore, the amount of key-employee life insurance that should be considered is more of an art than a science. Yet, a study of factors in the survival of businesses when key employees have died or suffered long-term disabilities shows that it is a vital art that CPAs and their clients ignore at their peril.

.14 **Advantages of Key-Employee Life Insurance.** There are a number of advantages of key-employee life insurance.

- The value of the business-owners' investment is stabilized and maximized immediately by the existence of key-employee life insurance coverage. During the insured's lifetime, policy cash values are carried as a corporate asset and can easily, quickly, and inexpensively be made available to the corporation for a business emergency or opportunity. At death, the infusion of large amounts of cash may serve as a shock absorber to cushion the impact of the key employee's loss.
- From the time the first premium is paid, the business *and* its creditors have the assurance of *instant capital* at the death of a key employee. Because a premium assures financial security, it is obtained cost effectively. In this sense, key-employee coverage can serve both as a form of commercial loan protection as well as collateral for securing future commercial loans. Many banks and other lending institutions may refuse to make large loans to closely held corporations unless life insurance in appropriate amounts has been obtained on pivotal personnel.
- A business receiving life insurance benefits at the death of an employee is not restricted regarding the manner in which that cash can be used. Key-employee proceeds can be used for a multiplicity of purposes including:

  — Finding a qualified replacement for the deceased key employee.
  — Paying for the training of the replacement.
  — Replacing lost profits.
  — Protecting the firm's credit rating.
  — Providing benefits under one or more employee benefit plans.
  — Financing a buyout of one or more deceased or disabled business owners.

.15 **Disadvantages of Key-Employee Life Insurance.** Key-employee life insurance also has its disadvantages and costs, among which are the following:

- The cash benefit provided by business-owned life insurance comes at a cost: premiums must be paid with after-tax dollars. Although large amounts of dollars become available as soon as the insurance is in force, the corporation must pay the opportunity cost; that is, it cannot use money allocated to premiums for any other corporate purpose, and it cannot deduct the premiums.
- To the extent that the corporate AMT applies (see discussion below), the utility of key-employee life insurance is diminished.

.16 Tax Implications of Key-Employee Life Insurance. Key-employee life insurance has important tax implications including the following:

- Premiums paid by the corporation are not tax deductible.
- Lump-sum proceeds are free of federal income taxes.
- For purposes of computing the corporation's AMT life insurance death benefits received by a C corporation can generate *adjusted current earnings and profits*. About 75 percent of the death proceeds in excess of the cash value at the date of the insured's death could be treated as a preference item. This means about 75 percent of the total proceeds would be subject to a 20 percent surtax in a worst-case scenario that is roughly equivalent to a 15 percent tax on 100 percent of the proceeds. So about $150,000 could be lost out of $1,000,000.

  — To compensate for a worst-possible-case AMT loss, the CPA can multiply the net amount needed by 118 percent to arrive at the necessary amount of insurance.
  — No AMT can be imposed on an S corporation, and it may be possible to make income-tax-free withdrawals of proceeds when the S corporation has no prior accumulated earnings and profits.
  — Even for C corporations, the AMT may be an illusory problem because a corporation can use the minimum tax credit for the entire AMT in excess of the regular tax to offset regular tax in later years. So even if a corporation has to pay an AMT because of the receipt of life insurance proceeds, in many cases it may be able to recoup its outlay through tax savings in later years. However, before adopting this concept, the CPA should factor in the time value of the money lost to current AMT.

- A corporation's earnings and profits may be increased to the extent that the death proceeds exceed total premiums in the case of term insurance or corporate-owned cash values in the case of permanent coverage.
- Premiums paid by the corporation *are* not taxable to the insured employee provided that person is given no current rights in either the policy or its values.
- For corporate-owned and other business-owned life insurance policies purchased after June 20, 1986, no interest deduction is allowed on interest incurred on loans in excess of $50,000 regardless of the number of policies on the insured's life. Corporations in a relatively low income tax bracket may have little interest in systematic borrowing in any event. Corporations in a high income tax bracket should consider policy loans up to the $50,000 limit as long as Congress allows full deductibility of the interest payments.
- The death proceeds of a corporate-owned life insurance policy on the life of a sole or *controlling* shareholder, one who owns more than 50 percent of the voting stock, are not included in the insured's gross estate to the extent that the proceeds are paid to or for the benefit of the corporation. But to the extent the proceeds of a corporate-owned life insurance policy on the life of a controlling shareholder are payable to a party *other* than the corporation or its creditors, those proceeds are includable — as life insurance — in the insured shareholder's estate.

- A controlling shareholder-insured is treated as holding *incidents of ownership* in a policy on his or her life purchased by the business to the extent the proceeds are not payable to the corporation. For instance, if a corporate-purchased policy with a face amount of $1 million is paid to the children of the insured controlling shareholder, the entire amount would be includable in the insured's estate. If only $700,000 were payable to the children, then $700,000 would be includable as insurance.
- If it is important to avoid federal estate tax on the death of the insured, *do not give* or allow the insured to have *any* incidents of ownership in the policy. The incidents of ownership include the right to name or change the beneficiary, borrow on the policy or use it as collateral, veto the corporation's right to name or change the beneficiary, and surrender or cancel the contract.

- If the death benefit that otherwise could (and should) have been considered paid to the corporation in fact is paid to a shareholder, the IRS is almost certain to argue that the entire amount is taxable as a dividend probably in addition to the estate tax inclusion. Failing the dividend argument, the IRS is likely to claim the entire proceeds should be taxed to the recipient as compensation. If that argument fails, the IRS could then argue that premiums for any open tax years be charged to the insured as dividends or compensation.
- Cash values of permanent coverage carried for a bona fide business purpose are not subject to the accumulated earnings tax.

.17 When to Consider Key-Employee Life Insurance. The CPA should consider using key-employee life insurance in the following situations:

- When the profits or the financial soundness of a client's business would be threatened or when a client's business may have a difficult period of adjustment following the death of a key employee, such as a leading salesperson or an employee instrumental in the development of new products.
- When the success of a business depends on the unique skills and abilities of one or more key employees, and the business's creditors insist that its indebtedness be collateralized through the purchase of key-employee life insurance.
- When a business desires to fund one or more of its liabilities at the death of one or more key employees (for example, the funding of large health and retirement benefits).
- When business owners have been required by creditors to co-sign or guarantee corporate obligations (for example, if a corporation defaults a key-employee insurance could protect those individuals and their estates who will be personally liable for paying off the debt).

Death-Benefit-Only (DBO) Plans

.18 A death-benefit-only (DBO) plan, sometimes called *survivors' income benefit plan*, provides payments to the survivors of an employee at the employee's death. As its name implies, a DBO plan provides only death benefits and makes no promises or payments to the employee during lifetime.

.19 Employers install a DBO by a written contract between the employer and employee. The agreement must specify the following:

- Amount of the benefit
- Employee (or employees) covered by the plan
- Class of beneficiaries entitled to the benefit
- Terms upon which the benefit can be forfeited
- Collection procedures

.20 A corporate resolution adopted by the company's board of directors should be entered into the corporate minutes well in advance of the time that payments are to be made, and preferably before the contract with the employee is signed.

.21 Life insurance is almost always used to finance the employer's obligation under a DBO. This guarantees that adequate funds are available to make promised payments even if the selected employee dies immediately after entering the contract. In fact, the employer may want to make payments contingent on the employee's insurability and actual coverage. This life insurance must not be mentioned in the contract with the employee. A linking of the life insurance with the promised benefits could cause unnecessary estate tax inclusion, income taxation on premium payments, and Department of Labor intrusion.

.22 Under a separate corporate resolution, the board of directors of the corporation should consider authorizing the purchase of the life insurance as *key-employee insurance*. (See paragraph 3/570.02 above.)

.23 Although most DBO plans make payments over a number of years (for example, $50,000 a year for ten years if death occurs prior to age sixty-five), a plan might provide for a lump-sum payment. For example, assume a plan promised a $100,000 death benefit to the surviving spouse of a key executive, otherwise to the executive's children. If the employer corporation expected to be in a 34 percent (or higher) income tax bracket at the time payments are made, it could purchase a $66,000 policy on the employee's life. The corporation would own and be the beneficiary of the policy and pay all premiums. When the employee died, the corporation would pay out $100,000 to the beneficiary and deduct that amount as compensation. This would save $34,000 in taxes. Note that the $66,000 of life insurance would be received by the employer/corporation income-tax free (and in this example would probably not be subject to any AMT).

.24 However, in the case of a larger life insurance policy, CPAs should consider multiplying the target amount the employer firm needs to net by 118 percent to find the proper level of insurance to purchase. For example, if the company needed to net $1,000,000, it should consider purchasing $1,118,000 to be sure that, in a worst-case situation, it would still net $1,000,000 after any corporate-level AMT.

.25 If the benefit is to be paid to employee's survivor over a period of years rather than in a lump sum, the amount of life insurance needed by the corporation is further reduced. This is because the corporation can invest the life insurance proceeds received at the date of the employee's death. Since the corporation can pay those funds over a number of years, it can continue to invest any balance and use the net after-tax interest income to help fund the benefit payments. Using a calculator or software package with discounting tables would quickly show the low cost of providing a large benefit when the employer can use both tax leveraging and the time value of money.

.26 **Advantages of a DBO Plan.** A DBO plan has a number of advantages including the following:

- Under 1990 tax law, if the covered employee is a shareholder who owns 50 percent or less of the stock of the corporation, payments under a properly established DBO plan are excludable from the gross estate. This avoidance of federal estate tax is particularly valuable to individuals whose estates for one reason or another may not qualify for a marital deduction.
- Large amounts of continuing income can be provided through a business to the survivors of a key employee. This significant financial assistance is available to both shareholder/employees and others.
- The value of the future benefits is not taxable to the employee during his or her lifetime, since the employee has no current right to payments or to the values in the life insurance used to finance the employer's obligation under the plan.
- Employers can choose who is covered under a DBO plan, the terms of that coverage, and the level of benefit payments to be provided to recipients.

.27 **Disadvantages of a DBO Plan.** A DBO plan has certain disadvantages and downside risks including the following:

- With the possible exception of a $5,000 exclusion, the entire payment by the corporation to the survivors under a DBO plan is subject to ordinary income tax.
- No deduction is allowed to the employer until the benefit is paid. Even if an employer sets funds aside in advance to meet promised payments (almost always through the purchase of a life insurance contract), the employer's deduction is deferred until benefits are paid.
- If the nondeductibility is a problem, the employer could scale back the promised benefit to a more palatable amount, for instance, to what it would have been had a current deduction been allowed. For example, if an employer objects to a $10,000 annual premium because it is nondeductible at the employer's 34 percent bracket, the CPA could suggest tailoring the benefit to what could be purchased by a $6,600 outlay that it would have cost the employer had a $10,000 deduction been allowed.
- To avoid federal estate tax inclusion of payments, an employee can have no right to name or veto the naming of the recipient of death benefit payments. Avoiding federal estate tax requires careful planning, which to some degree limits flexibility for controlling shareholder employees (51 percent or more).

- A plan covering a broad group of employees may have to comply with Employee Retirement Income Security Act (ERISA) provisions for vesting, funding, reporting, and disclosure. However, in most cases, a DBO plan may be limited to a "select group of management or highly compensated employees" and may, therefore, be exempt from all provisions of ERISA, except for a simple notification of the existence of the plan to the Department of Labor.

.28 **Tax Implications of a DBO Plan.** A DBO plan has several tax implications:

- Benefits paid to the employee's survivor are taxable in full as ordinary income just as if the payments were a continuation of the deceased employee's salary. A possible exception is an exclusion of the first $5,000 of income under IRC Sec. 101, but only if the benefit was forfeitable by the employee during lifetime. Thus, if the employee could have lost the benefit by some action or inaction (for example, terminating employment prior to normal retirement age), the $5,000 exclusion would be allowed.
- Benefit payments, to the extent that they represent reasonable compensation for the services actually rendered by the deceased employee, are deductible in full by the employer corporation when paid. As a practical matter, this issue arises only when (a) the decedent was a shareholder/employee, (b) the recipient is a stockholder, or (c) there is no written agreement to pay the benefit prior to the employee's death. In these cases, the IRS may attempt to disallow the corporation's deduction and treat the payments as a dividend rather than as deferred compensation.
- When the covered employee is a 50 percent or less shareholder, payments are excludable from the employee's gross estate. This assumes the employer specifies the recipient of the death proceeds (preferably by stating a class of beneficiary, such as "the employee's spouse if living, otherwise the employee's children in equal shares"). If the agreement gives the employee the right to name, change, or veto an employer's choice of beneficiary, payments will be includable in the employee's estate. The employee's estate should not be named the beneficiary. If a revocable trust established by the employee is named as the beneficiary, payments will be included in the beneficiary's estate because, by definition, the employee reserved the right to alter, amend, revoke, and terminate the revocable trust.

.29 The avoidance of estate tax assumes that the plan itself only provides death benefits and provides no post-retirement lifetime payments to the employee. But the IRS can link life time payments under other plans to the DBO plan and consider the two as a single plan even if they are separate plans. The result is that the IRS could treat the totality as if it were a joint and survivor annuity (payments for the employee's life followed by payments continuing to the employee's survivor). In this case, the lump sum paid to the survivor or the present value of the stream of payments to the survivor would be subject to estate tax.

.30 No rights over the life insurance policy used to finance the employer's obligation can be given to the employee. If the employee owns the policy or has any veto rights over any change in the beneficiary, the IRS would probably include policy proceeds in the employee's estate because of the employee's incidents of ownership.

.31 **When to Consider a DBO Plan.** A DBO plan should be considered when:

- The employer seeks an employee benefit that would help recruit and retain key employees.
- The employer wants an employee benefit that is simple, cost-effective (the employer makes no payments but retains the contract if the employee terminates employment), and free from administrative burdens.
- The employer wants to choose who is to be covered, under what terms and conditions, and at what amounts.
- The employer wants to supplement a qualified retirement plan.
- A shareholder/employee wishes to use his or her corporation to provide personal financial security.

Buy-Sell Agreements

.32 A buy-sell agreement is a contract restricting the right, on the happening of a triggering event, to dispose of a business interest to specified parties according to specified terms. Typically, this arrangement requires a sale of the business interest upon death, disability, retirement, withdrawal from the business at some earlier time, or in some cases upon attachment of the owner's property by creditors or in a divorce. The triggering events can vary depending on the needs, desire, and circumstances of the parties.

.33 Buy-sell agreements can take one of four different forms based on the parties to the contract:

A. *Stock redemption (entity purchase)*. On the occurrence of a triggering event, the business itself purchases the business interest, preferably under a formula-determined price. When the redemption is funded by life insurance, the corporation should be considered the applicant, owner, beneficiary, and premium payor.
B. *Cross purchase (crisscross)*. On the occurrence of a triggering event, the remaining business owners buy the business interest, preferably under a formula-determined price. When funded by life insurance, the owners should be considered the applicants, owners, beneficiaries, and premium payors.
C. *Wait and see*. When a triggering event occurs under this creative and highly flexible approach, the corporation is given a first option to purchase stock. At this stage the *wait-and-see* buy-sell agreement takes the form of a stock redemption plan. To the extent that option is not exercised in a timely manner, the remaining shareholders are given an option to purchase the stock. At this stage the wait-and-see buy-sell agreement is in the form of a cross-purchase plan. Any stock not purchased at the expiration of this second option must be purchased by the corporation in a stock redemption. The wait-and-see buy-sell agreement gives the parties the ultimate in

flexibility and the right to use a partial (IRC Section 303) redemption coupled with a cross-purchase agreement. In all stages the purchase price is determined by formula.

D. *Third party.* On the occurrence of a triggering event, a third party who has previously agreed contractually to purchase the business interest does so.

.34 For a wait-and-see buy-sell agreement, life insurance ownership is also very flexible; the insurance can be owned by the corporation, the shareholders, a third party, or any combination. When the death proceeds are received, they can be lent (at the current market rate of interest and fully secured) to the ultimate purchaser of the decedent-shareholder's stock.

.35 A binding buy-sell agreement is extremely important for most businesses with more than one owner and, in certain cases, such as a professional corporation or S corporation, a buy-sell agreement may be essential.

.36 When thinking about how much life insurance is necessary for proper funding of the buy-sell agreement, it is highly recommended that, if at all possible, the buy-sell agreement be fully funded from inception. This is because the value of a business interest and therefore the need for cash to buy that interest increases when the real value of the interest itself increases as well as a result of inflationary growth. For example, a business interest worth $500,000 today enjoying a 6 percent real growth and a 4 percent inflationary growth may be worth almost $1,300,000 just ten years from now and over $3,000,000 in twenty years.

.37 An important reason for full funding is that at the death of one owner, the value of the survivor's stock increases significantly. When there are three or more owners, this entails the purchase of more insurance at future dates.

.38 To help meet future needs, life insurance should be used to fund a buy-sell agreement by using insurance-policy dividends to buy *paid-up additions* or *one-year term insurance*.

.39 **Advantages of Using Life Insurance to Fund Buy-Sell Agreements.** The advantages of using life insurance to fund buy-sell agreements include the following:

- Remaining shareholders are assured that they are protected against new inactive and potentially dissident shareholders who often cause conflict over management policies, such as the size of dividends relative to salaries or risks the corporation should consider in accounting for growth. To the extent a buy-sell agreement is fully funded with life insurance, all the stock and, therefore, control can be vested in the hands of the remaining shareholders.
- Remaining shareholders can be assured that the profits produced by their own efforts benefit them rather than new inactive shareholders or the purchasers of those inactive shareholders' stock. Again, this is only true to the extent that sufficient life insurance is purchased to enable a complete buyout of the departing shareholder's interest.

- Remaining shareholders are assured that the transition of management upon a triggering event should flow smoothly and completely.
- Remaining shareholders are provided with a convenient means of fulfilling the natural sense of obligation that they could have toward a deceased colleague's family or to a retiring co-owner.
- Shareholders can effect changes in ownership percentages that may be appropriate when a shareholder dies, becomes disabled, retires, or for some other reason leaves the firm.
- Life insurance funding provides the means to meet most contingencies, has a relatively low cost, is simple to explain and implement, and may not adversely affect the working capital or credit position of the business.
- Life insurance is the only means of guaranteeing that death, one trigger that creates a need for cash, creates the cash to satisfy that need.
- A life insurance funded buy-sell agreement frees the survivors of the deceased shareholder from financial dependence on a business that has just lost a key individual and assures them of a fair (and hopefully sufficient) amount of both capital and income.

.40 Disadvantages of Using Life Insurance to Fund Buy-Sell Agreements. The disadvantages of using life insurance agreements to fund buy-sell agreements include the following:

- Premiums must be paid with after-tax dollars.
- Uninsurable shareholders present a problem. CPAs should note, however, that very few individuals are refused insurance because of age or physical health. Most insurers may agree to cover almost any age (up to the mid-seventies) and may insure illnesses by adding a *rating*, a charge that equates the total premium to the appropriate level of additional risk the insurer assumes.
- If a rated policy is prohibitively expensive or unavailable, CPAs should consider the following:

  — Recapitalize the corporation's stock into common and preferred stock (or declare a preferred stock dividend).
  — Make the common voting stock and the preferred nonvoting.
  — Assign to the preferred stock as much value as is reasonable.

  This has the effect of *watering* the common stock's value and making it easier to purchase. The common stock would be subject to a mandatory buy-sell agreement triggered at death and carry with it all voting and growth rights to the surviving shareholders. Preferred stock would pay a high but reasonable dividend to the survivors. It would be subject to a *call* by the surviving shareholders, but they could exercise that buyback right if and when cash flow permitted. Alternatively, the preferred stock could be repurchased through an installment sale.

- If there are more than three shareholders in a stock redemption plan, the corporation needs only one policy on each shareholder's life. However, in the case of a cross-purchase plan in which each shareholder owns a policy on each other shareholder's life, the number of policies (and therefore the administrative complexity, cost, and potential for error) multiplies each time new insurance is added because of an increase in the valuation of a stock interest. To ascertain the number of policies needed when a cross-purchase plan is used, multiply the number of shareholders by that same number less one: $N \times (N-1)$. So if there were four shareholders, twelve new policies would be needed each time the cross-purchase plan was modified.

.41 CPAs should consider an often-mentioned solution to the multiple-policy problem: use a trust. The shareholders in a cross-purchase agreement give cash to a trustee, who then purchases insurance on each shareholder's life on behalf of the others. Only one policy is necessary on each shareholder's life.

.42 Although the preceding statement is correct, when the first shareholder dies, the decedent's estate still has a beneficial interest in the policies the trust owns on the other shareholders' lives. When that interest is transferred to the other shareholders (regardless of the form of the transfer) who have beneficial interests in the trust, the surviving shareholders now have a right to insurance proceeds they did not have before. This could easily trigger the *transfer-for-value* tax trap described below at ¶ 5/570.43. The result could be a tax disaster for the surviving shareholders.

.43 Tax Implications of Buy-Sell Agreements. Buy-sell agreements have many tax implications:

- Premiums used to fund a buy-sell agreement are not deductible regardless of who owns the policy: the corporation, shareholders, or a third party. CPAs should, therefore, consider the comparative tax brackets involved in deciding whether to use the stock-redemption or cross-purchase approaches to funding a buy-sell agreement.
- If a corporation is in a higher income tax bracket than its shareholders, it may be wise to make tax-deductible salary or bonus payments to the shareholders and have them buy and own the insurance on a cross-purchase basis. If the corporation is in a lower bracket than its shareholders, it may make more sense to use a stock-redemption plan.
- Death proceeds are received income-tax free regardless of who owns the policy: the corporation, shareholders, or a third party.
- The general rule that death proceeds are income-tax free must be modified if the amount of insurance is large and the proceeds are payable to a C corporation, because the AMT must be considered. (See the discussion of the AMT in the coverage of key-employee insurance at ¶ 3/570.16.) The corporate AMT is not a problem if the owner/recipient is an S corporation, a partnership, or the co-shareholders or partners of the insured.
- The general rule that death proceeds are income-tax free is also changed if there has been a *transfer-for-valuable consideration* (the transfer-for-value rule). This is an extremely dangerous tax trap! *CPAs should never consider suggesting or*

permitting any transfer of an existing policy unless and until potential problems with the transfer-for-value rule have been ruled out!

- — The transfer-for-value rule provides that if a policy or an interest in a policy is transferred-for-valuable consideration, only the amount of the purchaser's consideration, including premiums paid after the transfer, is recovered income tax free. Thus, the transfer-for-value rule forfeits the income tax exemption enjoyed by life insurance (term or permanent) when a policy or an interest in a policy is transferred for *any* consideration.
- — A common situation that could trigger the trap is when a corporation owns life insurance on the lives of two or more shareholders to finance a stock-redemption buy-sell agreement. The trap is sprung when the corporation, for whatever reason (for example, because the firm's attorney suggested that the firm switch from a stock-redemption to a cross-purchase buy-sell agreement), transfers the policies on each shareholder's life to the other shareholders in return for their payment of an amount equal to the policy's cash value.
- — Fortunately, there are safe harbors. The transfer-for-value rule does not apply when transferee is the insured, the insured's partner, a partnership in which the insured is a partner, a corporation in which the insured is an officer or is a shareholder, or anyone whose basis is determined in whole or in part by reference to the transferor's basis.
- — Transfers of a policy or an interest in a life insurance policy to anyone other than those listed above—such as a transfer to a director or officer of the insured's corporation—are not protected. Relieving the transferor from repaying a policy loan or even from the burden of paying premiums is considered valuable consideration. Because of the high exposure, full tax analysis of the proposed transaction should be completed before proceeding.
- — For corporations that want to switch to a cross-purchase from a stock-redemption plan (perhaps to avoid or minimize the impact of the corporate AMT), CPAs should consider leaving currently owned corporate insurance on a *reduced paid-up* basis (the cash values in the policies pay future premiums but the death benefit is reduced) and using that corporate coverage as key-employee insurance. New coverage could then be purchased under the cross-purchase plan without fear of the transfer-for-value trap.

- Premiums paid by a corporation that is the beneficiary of a policy on the life of a shareholder will not be taxed to another shareholder as either a constructive dividend or as salary. However, if the corporation pays the premiums for a policy owned by a shareholder on the life of another shareholder, that payment is likely to be considered a dividend or compensation to the policy owner/shareholder.
- CPAs should consider using *split-dollar insurance* (explained below at ¶ 3/570.45.) Essentially, under split-dollar insurance, the corporation lays out all or the bulk of the premium necessary to pay for the insurance one shareholder buys on the life of another. The policy owner/shareholder takes the economic benefit received into income.
- Fortunately, to the extent that the corporate outlay is recovered by the corporation at the insured's death, the co-shareholder who owns the policy is not treated as

receiving the entire amount the corporation pays each year. Instead, the co-shareholder/policy owner reports as income only the *P.S. (pension service) 58 cost.* (P.S. 58 is a government table that provides the reportable income per $1,000 of pure insurance provided.) Thus, the co-shareholder/owner is taxed on the economic value of the pure term insurance the employer corporation is making available by what is in essence an interest-free loan.

- Typically, there are no accumulated earnings tax problem when cash value accumulations build up in policies used to effect a stock redemption. However, planners should consider documenting the business (as contrasted with the shareholder) purposes served by the accumulation. The accumulated earnings tax is not a problem when life insurance is owned by the shareholders under a cross-purchase plan because no corporate funds are involved.
- If one shareholder owns insurance on the life or lives of other shareholders (a cross-purchase plan), at the death of the shareholder, the policy or policies owned by the other shareholders on the decedent's life is not includable in the decedent's estate. But the cash values (plus premiums paid but unearned on the date of death) of the policies the decedent owned on the other shareholders' lives may be included in the estate.
- There is no estate tax inclusion of life insurance proceeds if a corporation (in the case of a stock redemption) is the owner and beneficiary of the policies.
- CPAs should consider checking the terms of the buy-sell agreement to ascertain the degree to which policy proceeds are excluded from the purchase price. This is a major decision in the drafting of a buy-sell agreement. If the insurance proceeds are ignored in a stock-redemption agreement, it could be said that the surviving shareholders realize a windfall at the expense of the decedent shareholder's family. On the other hand, the insurance gain is not the result of operating profits.
- Perhaps the best solution is to have the purchase price include the cash values (but not the death benefits) of the policies on the lives of all shareholders. This is appropriate because the cash values represent a corporate asset to which the insured shareholder had indirectly contributed.
- To *fix* the value of stock for estate tax purposes, the sales price in a buy-sell agreement must meet the following requirements:

  — The price must be determined by formula.
  — The formula must be based on currently accepted valuation techniques.
  — The result of the formula must approximate the fair market value of the business interest at the date of the triggering event.
  — The formula must be generally recognized as suitable for valuing the type of property involved.
  — At the time the buy-sell agreement is signed, it must be the result of good-faith arm's-length bargaining.

- Neither the IRS nor the courts are bound, for estate tax purposes, to the price established in a buy-sell agreement unless the seller would in fact sell the interest to a totally independent nonfamily member for that price and that party would pay that price assuming reasonable knowledge of the relevant facts. The IRS can presume that any agreement that does not satisfy the five tests below is per se a "disproportionate transfer of the enterprise," and it may include the appreciation in the decedent shareholder's estate under IRC Sec. 2036(c). CPAs should consider reviewing all buy-sell agreements for compliance with the estate-freeze rules introduced in the 1990 Tax Act. Existing buy-sell agreements should be reconsidered so that they reflect a more realistic price. Simultaneously, if appropriate, insurance funding should be increased to match the updated buy-sell agreement.

.44 **When to Consider Life Insurance for Buy-Sell Agreements.** CPAs should consider life-insurance funded buy-sell agreements when:

- It is essential or desirable to create a market for a business interest on the death, long-term disability, or retirement of an owner.
- A shareholder will be unwilling or unable to continue running a business with the family of a deceased co-stockholder or someone outside the business.
- The continuation of a business at an owner's death involves a high amount of financial risk, and it is desirable or necessary to convert the business into cash at that time. For example, if the client's estate is large and may not qualify for the estate tax marital deduction, a means to turn the business interest into cash at a fair price must be found so that taxes can be paid.
- Federal or state laws make it imperative that the *closeness* of a close corporation be maintained. For example, too many shareholders or the wrong type of shareholder could result in an involuntary termination of S corporation status. Likewise, in most states nonprofessionals may not be stockholders in a professional corporation. In at least one state, if no buy-back occurs within thirteen months of a shareholder's death, the attorney general of the state can revoke the corporation's charter, a potential tax disaster.

Split-Dollar Life Insurance

.45 Split-dollar life insurance is an arrangement (rather than a type of policy) usually between an employer and an employee, in which there is a sharing and splitting of one or more of the following:

- Premium outlay
- Death benefits
- Cash values
- Dividends
- Ownership

.46 Under the classic approach, the employer corporation pays that portion of the annual premium that equals the lesser of the increase in the policy's cash value or net premium. The employee pays the balance of the premium, if any.

.47 The purpose of a *splitting of dollars* is typically to make the purchase of necessary life insurance or to provide a fringe benefit for the designated employee. In return for the corporation's significant outlay, which is similar in essence to an interest-free loan but is taxed differently (see ¶ 3/570.56 below for more detail), the employee now has a significant incentive to remain with the employer. If the covered employee dies or terminates employment, the corporation recovers its outlay (an amount equal to the total cash value of the policy immediately before the employee's death). The balance of the death benefit is paid to the beneficiary selected by the employee.

.48 CPAs should note that the various ways a policy (term or permanent) can be split are only limited by the creativity of the parties and the willingness of one party to make available low cost insurance protection for the benefit of the other party. There are, however, five major approaches to making split-dollar arrangements.

A. In the *classic plan* described above, the employer pays an increasing amount each year and the employee pays a lesser amount as cash values increase relative to the total premium. For example, if the first-year cash value of a $100,000 policy is $0, the employer would pay nothing and the employee would pay the entire premium. If the increase in cash value in the second year is $1,800 of a $2,000 total premium, the employer would pay $1,800 and the employee would pay the $200 balance. If the cash value were to increase by $2,000 in the third year, the employer would pay the entire premium and the employee would pay nothing. The classic plan assures the employer that the risk of not recovering its outlay is minimal because it always has the legal right and practical ability to regain its outlay from the cash value in the policy. The classic plan is simple to explain to the parties and is easily drafted by an attorney. Unfortunately, an employee's outlay is highest in the very years when the ability to pay is lowest, in the early years of the plan. Furthermore, the ability to minimize tax costs is not optimized by this approach.
B. The *level-premium plan* is another way of splitting dollars. In this plan, the parties select a period of time, for example, ten years, and average the employee's share of the premium over that period. This approach significantly reduces the amount an employee would have to lay out during the early years. The cost of this advantage to the employee is that the employer must lay out more during the early years than under the classic plan, although if the plan stays in existence long enough, both parties will pay essentially the same as they would under the classic method. Obviously, if the employee terminates or the plan itself is ended in the early years, the policy cash value may not be large enough to pay back the employer for its total outlay. This problem can be handled in a contract between the corporation and the employee.
C. The *employer-pay-all arrangement*, as the term implies, requires the employer to pay the entire premium; the employee pays nothing. The advantage of this nonsplitting of premium dollars to the employee and the potential drawback to the employer are obvious: the employer risks loss if either the employee or the plan is terminated prematurely. As is the case with all other split-dollar arrangements, a contract between the parties spelling out the terms of the agreement could specify a reimbursement to the employer if the need arose.
D. The *P.S. (pension service) 58-offset plan* is a split-dollar plan under which the employee pays an amount equal to the P.S. 58 cost for the insurance coverage or the

net premium due if that amount is less. Any balance is paid by the employer. This concept is designed to eliminate the employee's income tax cost for the plan as described below under *Tax Implications* (see ¶ 3/570.56).

E. The *reverse-split-dollar plan*, as its name implies, reverses the classic ownership of cash values. The employee pays a share of the premium equal to each year's increase in the policy's cash value. The employer pays any balance. Reverse split dollar gives the employee rather than the employer the right to policy cash values up to the total of his or her premium payments. The employer is the beneficiary of the death proceeds in excess of the employee's share. Reverse-split-dollar plans are designed as *money fulcrums* for the employee. After a number of years, the employee can have a very large sum of cash. The major disadvantage of this reverse approach is that the tax implications are uncertain, as is the case with all split-dollar arrangements except the classic approach.

.49 CPAs should consider paying particular attention to the way split-dollar ownership is arranged. There are a number of advantages — as well as tax traps — associated with these ownership methods. The two most common policy ownership methods are the collateral-assignment method and the endorsement method.

.50 With the collateral-assignment method, the employee (or often a third party, such as an irrevocable trust) applies for the policy, is the policy's legal owner and pays policy premiums. The employer-corporation then makes what are in essence interest-free loans in the amount the employer is responsible to pay under the split-dollar contract. CPAs should note that for tax purposes, as will be described below, the employer's outlays are *not* treated under the interest-free-loan rules but rather under the special P.S. 58 economic benefit measurement tables.

.51 The collateral-assignment method favors the employee with greater legal protection because the employee starts and continues as the policy owner. The collateral-assignment method makes it easier to use a policy previously purchased by the covered employee in a split-dollar arrangement.

.52 Under the endorsement method, the employer purchases and remains the owner of a life insurance policy on the life of the covered employee. An endorsement to the policy is filed with the insurance company under which payment to the employee's selected beneficiary cannot be changed without the employee's consent or in some cases without the consent of a third party, such as a trustee, when the employee wishes to avoid incidents of ownership for federal estate tax purpose.

.53 The endorsement method gives the employer greater control over the policy. In most cases, it is simple to install, administer, and avoid state law restrictions on loans between corporations and their officers or directors. The endorsement method makes it easy to use an existing corporate-owned policy in a split-dollar arrangement.

.54 Advantages of Split-Dollar Life Insurance. Split-dollar life insurance arrangements are popular with both employers and key employees for the following reasons:

- A split-dollar arrangement is an extremely cost-effective tool that helps an employer recruit and retain key employees. The major cost of the plan is the after-tax opportunity cost of the use of the employer's outlay. The employer can, in most cases, recover the entire amount advanced on the employee's death (from the policy's death proceeds) or termination of employment of the covered employee (from the policy's cash value). The employer's cost is only the after-tax interest that could have been earned had the money been placed elsewhere in return for the benefit received, continued services, and a more secure, contented, and less distracted employee.

- An employer can pick and choose who is covered, the amounts of coverage, and the terms of the coverage, and vary these elements from employee to employee. Even shareholders, employees, and directors can be covered. No IRS approval is required. The plan can be terminated at any time.
- There are virtually no ERISA reporting and disclosure requirements for a split-dollar plan because these plans are typically provided only to a select group of top level employees. It is essential, however, that the employer's attorney draft a document spelling out the parties' rights and responsibilities under the arrangement.
- In most types of split-dollar plans, the employer's outlay is fully secured at all times.
- Split dollar is an arrangement rather than a policy. Thus, great flexibility and individuality can be built into the plan to meet the objectives and premium-paying abilities of the parties.
- The parties to a split-dollar plan do not have to conform to traditional structures or relations; for example, a corporation can split premium dollars with a subsidiary or even with an outside corporation, such as a key supplier or purchaser, to achieve a particular corporate objective.

.55 Disadvantages of Split-Dollar Life Insurance. There are, of course, costs and other disadvantages associated with a split-dollar life insurance policy including the following:

- Premium outlays are required of the parties to put and keep the insurance in force.
- Premiums are not tax deductible at any time by either party to a split-dollar agreement.
- The covered employee must report as income the economic benefit received under P.S. 58 rates. (This is explained in greater detail in the *Tax Implications* section below at ¶ 3/570.56.) Reportable tax costs rise appreciably as the insured employee's age increases. As a practical matter, this means most split-dollar plans may be ended as the insured grows older or after retirement.
- In most cases, a split-dollar plan must remain in effect for a relatively long period of time (ten to fifteen years) before policy cash values and dividends maximize the economic efficiency of the plan.
- The tax implications of various creative split-dollar arrangements are not certain. (See ¶ 3/570.56 below for more detail.)
- A classic split-dollar plan incurs the cost of drafting a relatively complicated agreement.

.56 Tax Implications of Split-Dollar Life Insurance. Under a split-dollar arrangement, each year that the insurance is in force the insured receives an economic benefit by virtue of the employer's outlay of cash. The covered employee is deemed to be receiving a term insurance policy and is therefore taxed on the cost of the term protection received in that year. The mechanism used to compute the includable income is the P.S. 58 table, a table of term insurance rates also used to compute the reportable economic benefit received when permanent life insurance is purchased inside a pension or profit-sharing plan. The employee reports the value (according to the government's table) of the term coverage for the year under the plan. The employee can reduce each year's reportable amount by the amount of the premium the employee paid in the year.

.57 An employee can substitute for the P.S. 58 term insurance cost the annual renewable term insurance rates of the company that issued the policy, provided those rates are lower than the government's P.S. 58 costs (as they often are).

.58 For example, an employee age fifty is to be covered by a split-dollar plan. The P.S. 58 rate for age fifty is $9.22 per thousand dollars of *pure insurance* (death benefit less cash value in that year). If the policy was for $100,000 and the cash value was $10,000, the pure insurance (also called *net amount at risk*) would be $90,000. The P.S. 58 rate of $9.22 would be multiplied by 90 to arrive at $829.80, the income attributable to the split-dollar arrangement that must be included in income.

.59 Various dividend options also affect the amount reportable. (See the table *Tax Results of Dividend Options*.)

.60 If the insured is also the controlling shareholder, the IRS may attempt to include split-dollar proceeds in the insured's estate. The rationale is that the insured's control of the corporation was tantamount to personal possession of incidents of ownership of a life insurance policy owned by the corporation on the insured's life. The corporation has incidents of ownership, and the insured controls the corporation and, therefore, the incidents of ownership, albeit indirectly. The IRS could make this argument even if the ownership of the policy is split solely between the corporation and an irrevocable trust or some other third-party beneficiary. Some authorities think that this problem could be avoided through a carefully designed split-dollar agreement.

.61 When to Consider Split-Dollar Life Insurance. CPAs should consider recommending a split-dollar arrangement when:

- An employer wants to provide a key employee or shareholder employee with a low-cost benefit.
- An employer seeks an employee benefit that is highly flexible, avoiding the aggravation involved in most other benefit plans yet yielding a high return in terms of employee appreciation.
- A corporation wants to facilitate a cross-purchase of its stock. Two or more shareholders can purchase policies on each other's lives and split the premium outlay with the corporation. Each would pay the P.S. 58 cost for the insurance owned on the other shareholder's life based on the age of the insured shareholder, not the age of the policy owner shareholder. At the death of the insured, the policy owner would receive the proceeds and use that cash to buy stock from the decedent shareholder's estate.

TAX RESULTS OF DIVIDEND OPTIONS

Dividend Option	**Income Tax Results**	
	To Employee	*To Employer*
Cash to employee	Taxable income	No deduction
Cash to employer	None	Not taxable
Reduce employee's share of premium	Taxable income	No deduction
Reduce employer's share of premium	No implications Not taxable	
Deposit at interest for employee	Both dividend and interest taxable	No deduction
Deposit at interest for employer	No implications	Dividend not taxable but interest is
Paid-up additions, cash value, and death benefit controlled by employee	Dividend taxable	No deduction
Paid-up additions, cash value controlled by employer; death benefit in excess of cash value controlled by employee	P.S. 58 cost of insurance from dividend taxable income	No deduction
One-year term insurance, death benefit controlled by employee	Dividend is taxable income	No deduction
One-year term insurance, death benefit controlled by employer	No tax implications	Not taxable

Source: *The Tools and Techniques of Employee Benefit and Retirement Planning,* National Underwriter Co., 1989, 162. Used with permission.

Executive Bonus (Section 162) Plans

.62 A Section 162 plan is an arrangement under which an employer pays additional compensation indirectly to one or more employees in the form of premiums on permanent life insurance policies insuring and owned by the selected employees. These plans are also called salary increase, executive bonus, executive life insurance bonus, or selective pension plans. The term *Section 162 plan* is derived from the fact that the corporation deducts the amount of the bonus/premium as an ordinary business expense under IRC Section 162. However, the employee includes the amount of that bonus/premium in income. For example, a client's corporation could select a key employee. The corporation would pay premiums on a policy on that person's life. The employee would report that additional compensation as income. The employee would own the policy and designate the beneficiary.

.63 **Advantages of Section 162 Plans.** Advantages to both the employer and the employee in establishing an IRC Section 162 plan include the following:

- The simplicity of the plan makes it easy for all parties to understand.
- No IRS approval is required.
- No paperwork must be filed with the Department of Labor (DOL). A Section 162 plan is totally exempt from DOL administrative reporting rules.
- The employer can pick and choose who is covered (there are no minimum or maximum numbers of employees that must be covered), the premium (additional salary) to be paid, and the terms of the arrangement. It is even possible to limit the plan to owner/employees who desire additional life insurance coverage. However, employers should always consider the reasonable compensation test applied to salary or bonus payments.
- All outlays by the employer are deductible ordinary and necessary business expenses to the extent that they represent reasonable expenses.
- The plan can be discontinued at any time, subject to any agreement to the contrary between the parties.
- From the employee's perspective, the plan is appealing because the cash values, as soon as they begin to grow in the policy, are available for any emergency or opportunity. The employee can also use policy dividends to offset tax cost.

.64 **Disadvantages of Section 162 Plans.** There are drawbacks to a Section 162 plan, which include the following:

- From the employer's perspective, the major disadvantage of a Section 162 plan is that the employee has the unfettered right to the policy and its values. The employee forfeits future contributions on leaving employment or failing to earn the bonus. Contrast this with a DBO plan, in which the employee receives nothing and the employer retains the policy if the employee leaves.
- The employee must report the bonus/premium as additional income without receiving additional cash to pay any additional tax. This problem can be solved through the so-called *double-bonus plan.* The employer gives the employee an

additional or *gross-up bonus* to pay the tax on the first bonus. In most cases, the premium bonus is not actually paid to the employee. The premium statements usually come to the employer's address and are paid by the firm with a corporate check. The gross-up bonus is then paid to the employee in cash. For example, to compute the total amount that the employer must pay for the employee to net enough to pay the tax premium would generate in 1991, multiply the premium by 145 percent [1/(1-.31)]. If the premium were $10,000, the employer would actually pay $14,500 to an employee in a 31 percent income tax bracket.

- The employee owns the policy and can, therefore, further alleviate the tax burden by using policy dividends, if any, to offset income tax costs. CPAs should consider reminding clients that dividends are not guaranteed and depend on a number of factors such as the insurer's investment yields, mortality experience, and operating expenses.

.65 Tax Implications of Section 162 Plans. The tax implications of Section 162 plans include the following:

- The employee must report the entire amount paid by the employer toward a Section 162 plan as additional compensation.
- Payments made by the employer to a Section 162 plan are tax deductible to the extent they are reasonable compensation, which is an ordinary and necessary business expense. If the covered employee is also a shareholder, caution should be taken to document the reasonableness of the size of the payment.
- Insurance death benefits received by the beneficiary of the insured are income tax free.
- As long as the employee retains the right to name or change the beneficiary, the proceeds are includable in the employee's estate. It is possible, however, for the employee to make a gift of the policy to an adult beneficiary or to an irrevocable trust through an *absolute assignment.* If the employee survives that transfer by more than three years and has given up all incidents of ownership in the transferred insurance, the proceeds would then be excludable from estate tax.

.66 When to Consider Section 162 Plans. The circumstances in which a Section 162 plan should be considered include the following:

- An owner-employee would like to build an asset base outside the business, which can be used for retirement or other needs or as a sheltering device for cash not needed in the business.
- Group insurance is either unavailable or inadequate.
- The employer would like to supplement the benefits of a qualified pension or profit-sharing plan.
- The employer wants to recruit, retain, help retire, or otherwise reward key personnel. The Section 162 plan helps to offset the discrimination against a firm's most constructive and productive personnel.
- The employer would like to assure post-death capital or income for the family of a deceased employee or additional estate liquidity for one or more of its officers or other key employees.

Nonqualified Deferred Compensation Plans

.67 Nonqualified deferred compensation is a contractual arrangement in which an employer promises to pay a future benefit to an employee (or to an independent contractor) in the form of continued salary payments for services rendered currently. This deferred compensation plan is nonqualified because it deliberately does not attempt to meet the onerous coverage and contribution requirements of qualified pension and profit-sharing plans. For example, an employer might promise a key executive that in return for her continued services until age sixty, she would receive (in addition to normal salary, other fringe benefits, and qualified pension or profit-sharing benefits) $50,000 a year for ten years if she lived, or that amount would be paid to her spouse or children at her death prior to retirement.

.68 Almost all nonqualified plans provide both lifetime and *at-death* payments. Life insurance is the primary tool of preference to finance the payments. Typically, a corporation purchases a life insurance policy on the life of each covered employee. The corporation owns the policy and names itself the beneficiary. The employee is given no rights in the policy and no right to name or change the beneficiary of the policy. In essence, the policy is held as a key-employee contract (see the discussion of key-employee life insurance at ¶ 3/570.02 above) and may be subject to the same tax rules applicable to all such policies. When the covered employee retires, the employer pays the promised annual payments from corporate surplus. The corporation holds the life insurance policy until the employee's death, thus realizing income-tax-free proceeds, which may help the business recover its costs and in some cases may even result in a net gain to surplus, even after figuring the time value of the employer's premium dollars. Insurance professionals refer to this as cost recovery deferred compensation.

.69 Advantages of Nonqualified Compensation Plans. There are four main advantages to life insurance financed nonqualified deferred compensation plans, especially when compared with qualified plans.

A. An employer can pick and choose who is to be covered, the levels of coverage (subject to the reasonable compensation limits for deductibility), and the terms and conditions of coverage. A plan can be designed to cover only one person, if so desired, because there are no nondiscrimination requirements to be met.
B. Reporting and disclosure requirements are minimal, which eases the employer's paperwork burden.
C. Employees covered by properly arranged life insurance-financed nonqualified plans do not pay income tax until benefits are actually received. Dollars growing over the deferral period currently grow tax free (inside the shelter of the insurance product) and therefore typically grow beyond the level the employee would have realized had no deferral occurred and had the employee invested the after-tax dollars.
D. Generally, the employee receives not only the deferred compensation and the income it has produced during the deferral period, but also the benefit of tax leverage. The employer takes the cash it has and pays it out as tax-deductible salary. Because of its deduction, it can pay a larger amount to the employee. For example, if an

employer in a state and federal bracket of 40 percent is obligated to pay out $10,000 a year, the after-deduction cost is only $6,000. However, the corporation could choose to incur a cost of $10,000 a year and in fact pay out $16,667 [$16,667 — (.40 × $16,667) = $10,000]. The formula in the agreement between the corporation and the selected employee could provide that the corporation would pay out a given percentage of earmarked cash funds on hand each year multiplied by a fraction reflecting the corporation's tax bracket that year.

.70 **Disadvantages of Nonqualified Compensation Plans.** There are a number of disadvantages or costs of nonqualified deferred compensation financed with life insurance that the CPA and client must weigh.

- The corporation's income tax deduction is deferred until the year income is taxable to the covered employee. This may be twenty or more years from the time the employer starts to pay premiums. However, if this is viewed by the employer/client as a problem, the employer can cut down the actual contribution to the amount it would have been if a current deduction were allowed. For example, if the client's corporation was in a 40 percent bracket (federal and state), and a deduction was allowed immediately, a contribution of $10,000 would result in a $4,000 deduction and therefore an after-tax cost of $6,000. Thus, if cash flow is a problem or current deductibility is an objection, a solution may be to contribute only $6,000 each year.

  — This disadvantage can be viewed from another perspective: The corporation's deduction is based not on what the firm puts into the plan but on what comes out. The firm's deduction may almost certainly be based on an amount much larger than its original investment. Furthermore, if corporate tax rates do increase between the time funds are contributed and the time benefits are paid, the value of the corporation's deduction, and therefore its leverage, also increases.

- From the employee's perspective, a nonqualified plan is less than *bulletproof*. By definition, a nonqualified plan does not meet the stringent reporting and disclosure procedures or fiduciary and funding standards mandated for qualified plans and therefore does not receive the protection afforded by government agencies to participants in qualified plans.
- To prevent current taxation of the employee, the plan is technically unfunded, that is, no money or other assets are set apart beyond the claims of the corporation's creditors. In essence, even if the employer has regularly been paying life insurance premiums to finance its obligation under the agreement, the employee relies not on the life insurance policy but rather on the naked (albeit contractual) promise of the employer that, "someday we'll pay you what we promised." Other than that contractual promise, the employee has no assurance. When the time for payments comes, the employer may not have adequate assets to satisfy corporate creditors. In return for the deferral of otherwise currently taxable income taxation, the employee must rely solely on the employer's promise. The bottom line is that a nonqualified plan is not as secure as a qualified plan.

- A nonqualified plan should not be considered unless there is a high probability that the corporation will be in existence and be fiscally sound when promised payments are to be made.
- Willingness to pay is another key indicator of the soundness of a plan from the employee's viewpoint. Yet, if there is a corporate takeover, regardless of what present management would have done, the employee has no assurance that the new management may keep the prior management's promises without a long, expensive, grueling lawsuit. Many new management groups have already shown an unwillingness to pay large obligations to retired executives and other key employees.

  — The current solution of choice to this potential problem is the *rabbi trust* (so named because the first such trust was established to provide post-retirement security for a rabbi). This is an irrevocable trust that holds the assets of the plan apart from the corporation but not apart from the firm's creditors. The employer gives up the use of plan investments and cannot get those plan assets back. They are dedicated solely to the employees covered under the plan with one major exception: If the employer becomes insolvent or bankrupt, the assets become available to the general creditors of the employer, which forces covered employees to line up like all other creditors. The rabbi-trust solution is one that is indicated when there is a fear that the management or ownership of the business is likely to change before all benefits are paid or that a hostile new management might not honor the contractual obligations of the company to its key employees.

- Life insurance benefits payable to the corporation may be subject to AMT at the corporate level. This means the employer must purchase enough insurance so that, even after any possible AMT, there is enough cash to meet the obligations under the plan. Although, at most, the AMT may be about 15 percent of the death benefit (and in most cases far less), it is suggested that the employer obtain about 18 percent more life insurance than the *target* amount, the amount needed to meet cash flow demands under the plan. Any excess proceeds can be used as key-employee coverage to cushion the financial shock of the loss of the key employee.

.71 Tax Implications of Nonqualified Deferred Compensation Plans. Nonqualified deferred compensation plans have several important tax implications including the following:

- In a properly drafted plan (that is, one that avoids constructive receipt and the economic benefit doctrine) the employee is not taxed on any income of the plan until benefits are actually or constructively received.
- Payments made to the employee or the employee's beneficiary from a nonqualified plan, either directly by the employer or through a trust set up to finance the plan, are tax deductible by the employer, when paid, to the extent they meet the ordinary, necessary, and reasonableness tests applied to all compensation issues.
- To the extent the employer finances its obligation under the contract with mutual funds, stocks, bonds, or other assets producing taxable income, that taxable income is reportable, as earned, by the employer at the employer's tax rate. This is another

reason why life insurance is so often the principal financing vehicle; the internal buildup of values inside a life insurance contract is currently income tax free.

- When assets are held inside a trust designed to hold the financing mechanism, the tax consequences are essentially the same. The trust, if properly drafted, may be considered a grantor trust for income tax purposes. This means all trust income, deductions, and tax credits are treated as if earned by the grantor (that is, the employer corporation) for tax purposes.
- The employee receiving benefits from a nonqualified plan reports ordinary income in the year in which a benefit is actually or constructively received. This same treatment also applies to survivors of the employee who receive benefits under the plan. Amounts received from the plan by beneficiaries are taxable as received at ordinary rates, with two exceptions: (1) Up to $5,000 can be excluded from income as an employee death benefit if the employee did not have a vested right to the benefit immediately before death; (2) To the extent the inclusion of the benefit results in federal estate tax in the covered employee's estate, an income tax deduction is allowed to recipients under IRC Section 691 for income in respect of a decedent.
- Contributions to a nonqualified plan are not subject to Social Security tax or federal unemployment tax until a year in which the employee no longer has a substantial risk of forfeiture. Fortunately for the employee, in most nonqualified deferred compensation plans, the employee is fully vested and cannot forfeit anything. Unfortunately, the cost of this nonforfeitability is that Social Security taxes apply immediately. Fortunately, this probably will have little or no impact on most executives covered under these plans because their earnings generally exceed the taxable-wage bases.
- A lump-sum death benefit or the present value of any death benefit payable to a beneficiary is includable in a deceased employee's estate. The discount rate for computing the present value of the stream of income payments varies monthly. It is the 120 percent of the Applicable Federal Mid-term Rate (AFMR), which is published monthly in the *Internal Revenue Bulletin.*
- A death benefit that is payable solely to a surviving spouse would qualify for the federal estate tax marital deduction. There may be no marital deduction if payments continue beyond the surviving spouse's death (such as they usually do in the case of payments for a fixed number of years), absent a timely and proper Qualified Terminable Interest Property (QTIP) election by the deceased employee's executor.

.72 When to Consider Nonqualified Deferred Compensation Plans. A life insurance financed nonqualified deferred compensation plan should be considered when:

- An employer wants to cut out, cut down, or supplant a qualified plan.
- An employer wants to provide certain key employees with tax-deferred compensation over and above what they are currently entitled to under the qualified plan rules.
- An employer wants to provide additional financial security to an employee under terms or conditions different from those applicable to other employees.

- One or more key employees want and need an automatic and relatively painless — though not without risk of loss through insolvency — investment program that uses the employer's tax savings to leverage the future benefits.
- A plan is needed to help a corporation recruit, retain, and retire key executives.
- A substitute for equity-based compensation packages is desired. This may be a way for a closely held corporation to compete with a publicly held business that can offer company stock and stock options.

Group Life Insurance

.73 Group life insurance, as its name implies, provides insurance for a group under a contract between the insurer and the employer. The size of the group is typically ten or more employees. But this type of insurance can be obtained for smaller groups as well. Technically, the insured individuals are not part of that contract. Almost 40 percent of all life insurance in force in this country is on a group basis.

.74 Group life insurance is almost always issued as yearly renewable term insurance, which means that the coverage expires at the end of each year but is renewed automatically without evidence of insurability. The premium rate per $1,000 of protection increases each.

.75 **Advantages of Group Life Insurance.** Group life insurance is advantageous to both the employer and employee for the following reasons:

- Most employees have come to expect group life insurance as part of the standard employee benefits package.
- Larger than standard group coverage amounts can help attract and retain key employees.
- Premiums for group life insurance are tax deductible by the employer.
- From the employee's perspective, group life insurance (especially with respect to the first $50,000) is an incredible bargain. In most cases employees pay little or nothing toward the coverage. Younger employees and those who have $50,000 or less of coverage have no reportable income and therefore pay no income tax even though they are receiving a constant benefit.
- Group life insurance usually requires no medical examination.

.76 **Disadvantages of Group Life Insurance.** There are, of course, certain costs associated with group term life insurance. These costs include:

- Group life insurance runs out or is significantly reduced at the very time it is most needed by most clients, that is, when they retire or otherwise terminate employment. This dropoff particularly affects wealthy clients with high post-retirement living standards or those who were using group life as part of a liquidity problem solution.
- The Table I cost (reportable income for tax purposes [see below at ¶ 3/570.77]) increases significantly as insured individuals grow older. Ironically, in the post-

retirement years when medical and other expenses are high but income is low, the reportable income from group term life is highest and, therefore, so is the tax payable.

- Because group life insurance is a *welfare benefit plan* it is subject to certain ERISA requirements and limitations, which should be reviewed and could add additional costs for the employer.
- When provided, group life insurance coverage must be provided for specified nondiscriminatory categories of employees. This increases the employer's cost significantly over plans that allow the employer to pick and choose who may be covered and on what terms.
- The employer's out-of-pocket cost can skyrocket if no new employees enter the plan. This is due to the yearly renewable term aspect of group insurance; as the pool of employees grows older the average age continues to climb if no young employees enter the pool. Consequently, the premiums climb, too.
- The actual cost to the employer is a function of the benefit formula, the age, the sex composition, and the actual experience of the group as well as the experience of any other groups with which the client's group may be pooled. When dealing with smaller employers such as a professional medical corporation with many older long-term employees the yearly renewable term insurance rates are guaranteed for one year only and may continue to increase if there are no new, young entrants.
- Certain design features must be built into the plan to gain the tax law (IRC Section 79) benefits (see below at paragraph 3/570.77).
- A group term life plan cannot cover shareholders who are not employees.

.77 Tax Implications of Group Life Insurance. Group life insurance has important tax implications including the following:

- An employee does not have to report as income the economic benefit that is the term insurance cost of the first $50,000 of life insurance coverage provided by the group plan.
- An employee must report the economic benefit of coverage in excess of $50,000. The amount reportable is computed by multiplying the rates shown in Table I below, by the amount of coverage in excess of $50,000. These monthly rates are added to determine the total annual economic benefit received and included in income by the employee. However, in the case of a contributory plan in which the employee pays a portion of each month's premium, the employee can reduce the includable amount by the amount paid.
- To compute the includable amount, follow these steps:

  1. Find the total amount of group term life insurance coverage in each calendar month of the taxable year.
  2. Subtract $50,000 from each month's coverage.
  3. Apply the appropriate rate from Table I below.
  4. From the sum of the monthly cost, subtract total employee contributions for the year.
- For example, a client is age fifty-six. Her employer provides her with $150,000 of group term life insurance. She makes no contribution to the coverage. The *excess*

amount over $50,000 is $100,000. The rate, .75 per $1,000, is multiplied by 100 to arrive at $75 per month. If she was covered for twelve months, her includable income for the year is $900. Had she made a contribution of $200, her taxable economic benefit would be reduced to $700.

Table I: Rates for Group Term Life Insurance

5 Year Age Bracket	Cost per $1,000 per Month
Under 30	$ .08
30 to 34	.09
35 to 39	.11
40 to 44	.17
45 to 49	.29
50 to 54	.48
55 to 59	.75
60 to 64	1.17
65 to 69	2.10
70 and older	3.76

- The Table I costs increase dramatically once the client reaches the early sixties. Group coverage at retirement becomes extremely expensive in terms of reportable income. Most group term life either drops off or is drastically curtailed at this point in time and, in many cases, may not even be available. This problem is particularly acute for shareholder-employees with group life significantly in excess of $50,000.
- One solution is the *executive bonus carve-out*. This is a simple arrangement that provides up to $50,000 of coverage for all employees (including retired employees) through the group insurance plan, but carves out selected employees for special treatment. Specifically, the employer provides the chosen individuals with individual term or whole life insurance, or both. The employer pays the premiums, which are reportable by the employee as income. To make up for the income tax burden, an additional bonus is paid in cash to the employee (see discussion of Section 162 plans at ¶ 3/570.62 above). This is particularly appealing when the corporation is in a higher bracket than the executive is.
- Permanent insurance is often preferable in a group carve-out because the goal is to reduce or eliminate the out-of-pocket cost and reportable income of retired executives. This can be accomplished by using *vanishing premiums*.
- The bonus should meet the reasonable compensation test to avoid IRS challenge. The business justification for the arrangement should be spelled out in the corporate resolution adopting the carve-out. Possible reasons for adopting a carve-out could be recruiting, retaining, and rewarding key employees in addition to similar benefits offered to key executives of competing firms.
- The amounts reportable as income by the employee are treated as additional salary for purposes of FICA and FUTA, which means the employer must pay payroll taxes on the reportable amounts. State unemployment and workers' compensation taxes could also apply in some states.

- A beneficiary of group life insurance can receive the death-benefit income tax free.
- If the proceeds are payable to or for the benefit of the insured's estate or if the insured holds any incident of ownership at death regardless of who is named beneficiary of group term life insurance, they are includable in the insured's estate.
- If estate taxes are an issue, clients should consider an absolute assignment *for love and affection* of rights in group term life insurance, provided both the master contract between the employer and the insurer as well as state law permit the assignment. It still may be successful and may avoid the federal estate tax even if there is no specific provision in the master contract or in the state statute allowing the assignment.
- The policy owner must transfer all rights, including the right to convert the term insurance to permanent coverage. The transfer must occur more than three years prior to the insured's death to avoid its inclusion in the gross estate.
- Premiums paid by an employer for group term life insurance are income tax deductible as business expenses.
- If a plan discriminates in favor of key employees, with respect to eligibility or the kind or amount of benefits, the key employees become taxable on the entire amount of life insurance coverage. The exclusion for the first $50,000 is lost. If there is discrimination, the key employees (and only key employees) must include the higher of the actual cost or Table I cost of all insurance provided on their behalf in income.

.78 When to Consider Group Life Insurance. Group life insurance should be considered when:

- An employer wants a means of acquiring an employee benefit that most employees appreciate and even expect.
- Insurance is difficult to obtain at standard rates because one or more key employees have a health condition. Group insurance might be the most cost-effective solution.
- An employer would like to provide a cost-effective means of providing life insurance protection in amounts up to $50,000 for shareholder/employees as well as others. Above $50,000, the client may be better off purchasing individual term or permanent coverage.

3/575 PERSONAL LIFE INSURANCE STRATEGIES

Introduction

.01 Life insurance is used for personal needs in three major areas:

1. To replace the *human life value* of a wage earner. Thus, the insurance proceeds provide food, clothing, shelter, and pay for the other living expenses of survivors or liquidate existing debts at the major earner's death. This area has already been explored in detail in this module.
2. To provide for estate planning needs, mainly to provide capital to pay debts (including death taxes).
3. To transfer wealth to the next generation. Tax law is now making it so difficult to shift wealth from one generation to another that, in many cases, life insurance is

the only way to assure future generations the same standard of wealth and income enjoyed by their seniors.

.02 Life insurance itself can be considered an *instant estate.* The acceptance of the risk by the insurer and the payment of the first premium create an estate at that moment, but how the life insurance is arranged makes all the difference in the efficiency of that life insurance for the client and the client's family.

.03 It is impossible in a work of this scope to explore in detail life insurance as an estate planning tool in this section. Instead, this commentary focuses on common estate planning mistakes and how to avoid them. It then concentrates on the irrevocable life insurance trust as a major device for creating wealth free of estate tax to provide estate liquidity. Last, the use of life insurance to meet charitable objectives is reviewed.

Strategies

.04 Common Estate Planning Mistakes Involving Life Insurance. It is important to review all of a client's policies and attempt to coordinate them with the client's (and beneficiary's) circumstances and objectives. Specifically, the CPA should consider avoiding the following common mistakes:

- Life insurance is payable to the beneficiary at the wrong time. The beneficiary could receive payment before being emotionally, physically, intellectually, or legally capable of handling large sums of money.

  — Quite often the solution is to make the insurance payable to a previously established *living* trust into which not only the life insurance but also the assets passing under the client's will can pour over. The result is a unified and organized management, investment, and distribution process with adequate safeguards and advice available to beneficiaries who need that kind of help.

- Life insurance is payable in the wrong manner. Quite often, the beneficiary may be capable of handling money, but as income rather than as capital (that is, in small amounts over time rather than in a large chunk).

  — Again, a possible solution is to make the life insurance payable to a previously established trust that could pay out income as needed or at the trustee's discretion.
  — In addition, the trust can be drafted to pay given percentages of principal at future dates or at ages when the beneficiary may be more competent.
  — For example, the trust could provide one-third of the principal to be paid out at age twenty-five, one-third at age thirty, and the balance to be paid at age forty.
  — This timed distribution system may help the beneficiary to learn how to handle large sums of money while providing back-up capital and investment expertise.

- Not enough life insurance has been purchased. Not enough life insurance has been purchased on the life (lives) of the key person(s) in the family or the key person in the business. This is an indication that the CPA needs to help the client stabilize and minimize the loss of the human life value. (See commentary on key employee insurance above at ¶ 3/570.02.)

- The proceeds of life insurance are payable to the insured's estate. Naming the estate as beneficiary of life insurance needlessly subjects the proceeds to:

  — The costs and delays of probate.
  — The claims of the decedent's creditors.
  — State death taxes (in many states).
  — An election against the probate assets by a surviving spouse.
  — The imposition of the federal estate tax on the proceeds.

  By naming a specific beneficiary (person, trust, or charity) other than the insured's estate and naming at least two backup (contingent) beneficiaries the proceeds are not includable in the client's estate.
- Many CPAs suggest that the client name a charity as a final contingent beneficiary to eliminate any possibility of reversion.
- The life insurance is transferred within three years of the insured's death. This allows the IRS to attempt (usually successfully) to include the proceeds of the policy in the insured's estate. It is impossible to know when a client may die. The intended beneficiary, acting without direction from the insured, using the beneficiary's own money, should apply for and purchase insurance on the life of the client. If the policy is not payable to the insured's estate and if the insured never owned the policy nor possessed any incidents of ownership in the policy, it is not includable in the estate. If necessary, the client can make unrestricted gifts of cash (preferably on the beneficiary's birthday, anniversary, or at holidays), that then can be used by the beneficiary (or trustee on behalf of the beneficiary) to buy and maintain the insurance on the life of the client. It is strongly suggested that the amount given differ in a reasonable amount from the premium.
- The wrong party is named as beneficiary. Whenever a policy on one party is purchased and owned by a second party, the second party should be the beneficiary. A corporation should be the beneficiary of a policy it owns on the life of an employee or shareholder. A spouse should consider naming himself or herself as beneficiary of a policy owned on the life of the other spouse. To assure the desired result, a trust is established so that if the spouse owning the policy dies before the insured spouse, the policy does not go to the surviving spouse (and therefore be includable in the estate) but instead will go to the trust for the couple's children through a contingent ownership provision that can be inserted at no cost to the policy itself. Tax disaster is easily triggered in three situations:

  1. A corporation owns a policy and pays premiums but names anyone other than the corporation (or its creditors) as beneficiary. The IRS could attempt to include the policy in the estate of a controlling shareholder-insured (an owner of 51 percent or more of the voting stock) and also claim that the entire amount of the proceeds be taxed as a dividend (or at best as compensation).
  2. One person purchases insurance on the life of a second person and names a third party as beneficiary. The IRS could claim that the policy owner, at the

moment the insured died and the policy proceeds became payable, made a gift to the third-party beneficiary. The most common example of this unexpected tax nightmare is when a spouse purchases a policy on the other spouse's life and names their children as beneficiaries. The entire death proceeds could be treated as a gift from the spouse to the children. Worse yet, gift splitting would not be allowed since at the moment of the insured's death there is no spouse with whom to split the gift.

3. Life insurance is payable to the wrong beneficiary and occurs when a client remarries but forgets to change beneficiaries. A number of recent cases illustrate that courts may enforce the policy beneficiary designation regardless of how unfair the results may seem. This is so even if a divorce decree or the client's will provides for a different disposition of the life insurance. Check the latest beneficiary designation and confirm it in writing with the insurance company. Many times the client may think it was changed but it was not. Because a client's life circumstances change, constant confirmation that both the present and the contingent beneficiaries are those the client desires is an essential part of the client's financial plan.

- A life insurance policy is transferred for a valuable consideration. Generally, the transfer of a life insurance policy for a valuable consideration will subject the proceeds to income tax. Otherwise income-tax-free proceeds are subject to tax as ordinary income, even if the policy is term insurance or a permanent policy with no cash values. The IRS can claim a transfer for value even if no cash changes hands. For example, the IRS has held that when one party relieves another of premium payments there is a valuable consideration. Likewise, if a policy is subject to a loan, the acceptance of the policy subject to a loan in excess of the policy owner's basis is a valuable consideration. Whenever a life insurance policy is transferred, no matter how innocent the circumstances may seem, the tax implications of the transfer should be considered.
- Life insurance is used in a divorce with the divorcing spouse named as a revocable or irrevocable beneficiary. In many cases, a spouse is required by a divorce or separation agreement to purchase or maintain life insurance on that spouse's life and name the other (former) spouse as a revocable or irrevocable beneficiary. This could result in problems for both parties. The insured spouse receives no income tax deduction for the premium payments, no matter how large they are, regardless of what they are called in the divorce or separation agreement. The insurance is, however, includable in the insured spouse's estate, even though the other (former) spouse receives it.

  — Unless precautions are taken, the other (former) spouse has no assurance that the premiums have been paid and, in the case of a permanent policy, may not know if cash values have been stripped from the policy.

  — The solution is for the divorce or separation agreement to require the insured spouse to allow the other (former) spouse to purchase a new policy on the insured spouse's life. The other (former) spouse should own and be the beneficiary of the policy to be sure the premiums have in fact been paid and the cash values are secure. The insured spouse could increase alimony payments and obtain an income tax deduction for otherwise nondeductible premium payments. Because the insured spouse has never owned the policy, it will not be in the insured's estate. Both parties to a divorce should consider immediately reviewing the life insurance coverage for adequacy and suitability to the new and changing situation.

- Life insurance that is transferred to a beneficiary (or to a third party, such as a trust) and is held at death by the insured needlessly adds to the federal estate tax burden. There are many reasons why a timely gift of life insurance makes sense and has estate tax savings potential:
  - Typically the donee is unlikely to dispose of a life insurance policy or spend it, as could be the case with cash gifts.
  - A gift of life insurance could enhance the bond between the donor and the donee.
  - The donor may not lose significant financial assets or income as a result of the transfer.
  - Psychologically, the donor has begun the transfer-of-wealth process with little emotional pain and minimal perceived loss of wealth. Successfully completing this step could be the key to enable the client to begin to implement other estate-planning techniques.

.05 Using Irrevocable Trust. A trust is a legal relationship created during the lifetime of the grantor (the person setting up the trust) in which one party (the trustee) holds property for the benefit of another (the beneficiary). A trust created during the life of the grantor is called an *intervivos trust*, while one created by the grantor's will is called a *testamentary trust*.

.06 An irrevocable trust is one in which the grantor (client) gives up the right to alter, amend, revoke, or terminate the trust or to recover assets placed into the trust. In return for this surrender of rights, the client gains a number of intrafamily tax advantages. These advantages could be leveraged to an incredible degree through the use of properly arranged life insurance that is purchased by (or contributed to) and payable to the trust.

.07 An irrevocable life insurance trust can provide essential estate liquidity (cash to pay taxes and other death-related expenses) without adding to the estate's tax burden: the trustee can use life insurance proceeds to purchase assets from or lend money to the estate of the deceased insured-grantor. The purchase of assets from the estate results in cash to the estate and property in the hands of the trust and, therefore, its beneficiaries.

.08 Advantages of an Irrevocable Trust. The following are some of the many advantages of an irrevocable life insurance trust:

- An irrevocable life insurance trust is an excellent vehicle for shifting the responsibility to safeguard, invest, and distribute principal and income produced by cash, securities, real estate, and life insurance proceeds. The larger the portfolio, the greater the utility of the trust.

- Continuity of management and income flow are assured through an irrevocable life insurance trust. As soon as death occurs, the life-insurance proceeds become available to the trustee. This money can be invested with the other assets in the trust in a unified, coordinated manner.
- Estate-administration costs and delays are avoided or at least minimized.
- Significant federal estate and state death tax savings can be realized.
- The use of life insurance that is not subject to tax is used as leverage to reduce federal estate tax. Thus it can be said that life insurance held in an irrevocable trust enables payment of federal estate tax *at a discount*. If policy dividends are applied to purchase paid-up additional insurance or one-year term insurance, the money available to pay estate costs through life insurance could be much more than the premium cost (even when compounded at interest).

.09 Disadvantages of an Irrevocable Trust. As is the case with all other tools there are costs associated with an irrevocable life insurance trust:

- When setting up an irrevocable trust, both out-of-pocket and indirect costs will be incurred. Depending on the degree of complexity, legal fees may run up to $5,000 or more. If the trust is funded (income-producing assets are placed into the trust during the client's lifetime), trustee's fees could be incurred, and annual income tax returns must be filed. A gift tax could be incurred if a large life insurance policy with high cash values is transferred to the trust.
- By definition, once property is placed into an irrevocable trust, the grantor cannot recover it. Furthermore, the grantor gives up the right to change the terms and conditions of the gift made to the trust's beneficiaries as well as the right to name new beneficiaries or to deny benefits or change the benefits of those already named.

.10 However, any loss of control is mitigated by the fact that life insurance (especially group term) has little value (other than the loss of the use of the funds used to pay premiums) to the client during lifetime. The present value of the premiums is lost, so an income stream is potentially contracted unless the insurance would have otherwise been purchased. Unless special care is taken, a client who divorces and remarries will have difficulty changing the disposition of the life insurance proceeds. Flexibility can be added to the trust through a provision that states: "In the event of my divorce, any rights held by __________, my former spouse, are to terminate and to pass instead to my children." This language should be reviewed with the client's attorney.

.11 Tax Implications of an Irrevocable Trust. There are many tax implications of an irrevocable trust including the following:

- None of the assets in the trust, such as life insurance owned by and payable to the trust, are includable in the grantor's gross estate provided the grantor does not retain the right to:

  — Trust income
  — Trust principal

— Say who gets trust income or principal
— Regain trust assets
— Alter, amend, revoke, or terminate the trust
— Change trustees

- However, if a transfer of a life insurance policy is made to a trust within three years of the grantor's death, the proceeds of the policy may be includable in the grantor's estate for federal estate tax purposes. A mere unrestricted transfer of cash to the trustee may not trigger inclusion of either the proceeds of a life insurance policy or the cash.
- It appears that the secret of success is to be sure that all the facts indicate that the trustee purchased the life insurance on the insured grantor's life and paid the premiums independently. The trustee cannot be required to buy the insurance for the insured's agent, but rather because the trustee, acting independently, decided that purchasing and maintaining the insurance was in the best interest of the trust's beneficiaries. The odds for success may increase if:

  — The trustee is not required to pay premiums.
  — The insured-grantor is not required to make contributions to the trust.
  — The contributions made to the trust by the insured are not tied to the life insurance premiums in amounts or in terms of when required (for example, contributions are made on birthdays, anniversaries, and so on).
  — The trustee is given broad powers to act on behalf of the trust beneficiaries, including the power to purchase and maintain life or disability insurance on any person in whose life the beneficiaries have an insurable interest.
  — The trustee is independent.

- A fail-safe mechanism would be a provision stating that: "If death occurs within three years of the transfer of a life insurance policy to this trust, or for any reason the assets in this trust become subject to the federal estate tax, the proceeds of this trust are to pass to my surviving spouse in a manner that qualifies for the federal estate tax marital deduction." This language should be reviewed with the client's attorney.
- Income earned by the irrevocable trust will be taxed to the trust or its beneficiary rather than to the grantor if trust income cannot be:

  — Distributed to the grantor or the grantor's spouse.
  — Accumulated for future distribution to the grantor or the grantor's spouse.
  — Used to pay life insurance premiums on the life of either the grantor or the grantor's spouse.
  — Used to support a person whom the grantor is legally obligated to support.
  — Used to discharge any legal obligations of the grantor.

- Generally the grantor will be taxed on trust income if it is applied in any of these ways or if the grantor (or the grantor's spouse) retains a significant reversionary interest (the right to regain the property), or the power to decide who can receive trust principal or income, or when it may be received.

- Income distributed to the beneficiaries of an irrevocable trust is generally taxed to them (under kiddie tax rules if the child is under age fourteen). The distributed income retains its character. Thus, tax-free income to the trust is tax-free to the recipient.
- Income accumulated in the trust for future distribution to beneficiaries is taxed initially to the trust. Later, when distributed to the beneficiary, that income is taxed as though it had been distributed to the beneficiary each year but with credit for any taxes paid by the trust each year as it was accumulating the trust income. This is the *throwback rule.* Fortunately, if a beneficiary of a trust was under age twenty-one during the accumulation period, income accumulated until age twenty-one is not taxed a second time. The throwback rule does not apply to this income.
- Transfers to an irrevocable trust are a completed gift for gift tax purposes. The transfer, including the client's payment of life insurance premiums or transfers of existing policies, is subject to the federal gift tax. (See the discussion of charitable gifts of life insurance at ¶ 3/575.13 below for more details on the valuation of life insurance for gift tax purposes.)
- If the grantor allows the trust's beneficiaries the immediate, unfettered, and ascertainable right to use, possess, or enjoy any contribution, the gift will be considered to be a gift of a present interest. Provided the present interest gift is of a specified amount, it would qualify for the annual gift tax exclusion and it would, therefore, not be subject to the gift tax, or require the use of any of the grantor's unified credit.

  — The power in the beneficiaries that makes the present interest exclusion possible is generally called a *Crummey power*, unless it exceeded the amount of the annual exclusion. The name comes from the name of the taxpayer who first successfully defended the use of the technique in a court case. The Crummey power is a compromise between the grantor's desire to restrict the beneficiary's time and manner of enjoyment of trust principal and income and the Internal Revenue Code requirement that this same beneficiary have the immediate, unfettered, and ascertainable right to use, possess, or enjoy that property. A risk is taken each time a contribution is made by a grantor who gives a beneficiary the temporary and noncumulative right to demand the amount contributed. If that right of withdrawal is not exercised within the specified time limit, it *lapses*. The grantor's contribution to the trust remains in the trust and does not accumulate, that is, the amount the beneficiary elects not to withdraw in a given year cannot be taken down at some later date.
  — The attorney drafting the trust should build a formal notification system into the trust. If the right to withdraw is to be real and legally sustainable, the beneficiary must be given effective notice. It is suggested that each beneficiary who has a Crummey power be sent a certified letter with a return receipt requested (evidence that notice was received) giving the beneficiary at least thirty days from the time of receipt to make a withdrawal. Letters to a minor beneficiary are sent to a legal guardian.
  — The grantor's contribution should be made at least one month prior to the date it is actually needed to make a premium payment. If the trust immediately uses the grantor's money to pay premiums and does not have that money available for

the beneficiary to withdraw, the IRS could argue that the power to demand (Crummey power) was illusory.
— When a beneficiary chooses not to take money that could have been taken, that money goes to a remainderman, the beneficiary who takes what is left in the trust when prior interests end. In essence, by not taking the amount that could have been withdrawn, the holder of the Crummey power is making a gift to that person who will receive that income at a later date.
— The gift resulting from the failure to exercise a Crummy power is a gift of a future interest because the ultimate recipient's right to it is not immediate. There are a number of gift, income, and estate tax implications of future interest gifts. For example, because a future-interest gift does not qualify for the annual gift tax exclusion, some of the grantor's unified credit might have to be used, or a gift tax could be payable. Gift tax returns would also have to be filed for each year.
— Fortunately, the tax law ignores these problems to the extent that the gift in any year does not exceed the greater of $5,000 or 5 percent of the trust principal. For this reason attorneys will usually draft the trust to provide that the Crummey power cannot exceed $5,000 or 5 percent of the trust's principal in any given year. The grantor's payment of life insurance premiums that exceed the greater of these two amounts may eventually require use of the unified credit to offset gift taxes — a small price to pay for the substantial estate tax liquidity gained at a discount.

- On the death of the grantor, the proceeds of the life insurance are received income tax free by the trustee.

.12 When to Consider an Irrevocable Trust. In the following situations, an irrevocable life insurance trust could be considered:

A. The client can afford to part with one or more life insurance policies and has no conceivable expectation of a need for the cash values in the policies.
B. The client is relatively sure that the circumstances and objectives of the parties will not change drastically or that the terms of the trust can be drawn sufficiently broadly to encompass any anticipated changes.
C. The client has a large amount of group term life insurance that he or she wishes to exclude from the gross estate.
D. The client would like to *even up* the estate; that is, when there is concern that the children must receive equal inheritances but one child has already (perhaps through a family business) received a disproportionate share. Life insurance can be used to solve the problem of equalizing inheritances among children by either naming one child as beneficiary or making an absolute assignment of a policy to that child.

.13 Using Life Insurance to Meet Charitable Objectives. A transfer of cash or other property to specified charitable, religious, scientific, educational, or other organizations can result in income, gift, and estate tax benefits for the donor. Income taxes can be reduced and estate taxes can be saved. More important, a gift to charity serves to reward the donor in more significant psychological and moral ways. Charitable giving is, therefore, one of the most important of all financial planning activities.

.14 Life insurance is an important vehicle for accomplishing charitable objectives and is used in one of two ways: as a direct means of benefiting the charity or as a way to allow the donor to give other assets to charity during lifetime or at death without denying or reducing the financial security of the family unit.

.15 **Strategies for Providing Life Insurance Gifts to Charity.** The following are some of the strategies used to provide direct gifts of life insurance to charity:

- Existing life insurance policies can be donated to charity.
- Cash can be contributed directly to a charity, which in turn can be used to purchase a new policy on the life of the donor (or other supporters).
- The charity can be named a revocable or an irrevocable beneficiary of a life insurance policy.
- A contribution of an asset can generate an income tax deduction that in turn can save money the client would otherwise pay in tax. This tax saving can then be given to the client's children or another beneficiary who could use that cash to purchase life insurance on the client's life. The charity receives an immediate and certain gift, and the client's beneficiaries receive what they would have received (in some cases even more) had there been no charitable gift. Arranged properly, because life insurance can be estate tax free, all parties could end up with more than if life insurance were not used.

.16 When property is donated directly to charity, any savings from the resulting income tax deduction are then given by the donor to personal beneficiaries who purchase and maintain insurance on the donor's life. The amount of the insurance should be at least enough to make up for the property the heirs would have received had no gift been made to charity. In some cases the heirs buy only that amount they would have received after federal and state death taxes.

.17 An immediate tax saving is available for the client who sets up a charitable remainder trust retaining the income for life or a given period of years personally or together with one or more other persons. After the life (or lives) for which income has been retained ends, the charity receives the principal in the trust. The client receives an immediate income tax deduction for the present value of what the charity may someday receive. The tax saving is then given to a personal beneficiary who purchases life insurance on the lives of the client and the client's spouse (or a policy that pays on the death of the survivor of the two) to replace the wealth given to the charity. Because the insurance is not in the client's estate, it bypasses both state and federal death taxes. Beneficiaries may end up with more wealth than if no charitable gift were made.

.18 **Advantages of Using Life Insurance for Charitable Giving.** Among the reasons for using life insurance for charitable giving are the following:

- The death benefit of a life insurance contract owned by or payable to a charity is a guaranteed gift as long as the insurance is maintained in force by the payment of premiums. This distinguishes life insurance gifts from the typical *maybe* gift, in which the charity may be the beneficiary or it may not; and maybe the charity may receive what has been promised (or often only hinted) or maybe not. Furthermore, the life insurance gift is fixed in value and not subject to the risks of the securities or real estate markets.

- Life insurance can be thought of as a way to *provide amplified immortality on the installment plan*. A client who might not otherwise be able to afford a significant gift can increase a given number of dollars by leveraging them through life insurance. Furthermore, premiums can be spread out over the client's entire lifetime making the payment of the gift less burdensome.
- Life insurance provides a way for individuals who might otherwise not be able to make gifts to do so. Through life insurance, for instance, an ultra large gift can be made without impairing or diluting control in a closely held business. The charity is benefitted while the family's financial security is maintained or perhaps enhanced.
- Life insurance is a cost-effective means of making large charitable gifts. Life insurance is free of probate or administrative fees, delays, or any other transfer costs. It is not subject to the claims of ex-spouses or even current ones, disgruntled heirs, or creditors. The charity, therefore, is more certain of that receipt.
- A gift to charity through life insurance can be completely confidential. Conversely, if publicity is desired, it can be arranged very effectively. For instance, a church or synagogue could establish a *Millionaires Club* consisting of individuals who donated $1 million or more.

.19 Disadvantages of Using Life Insurance for Charitable Giving. The costs involved in using life insurance for charitable giving include the following:

- Life insurance requires the payment of a stream of dollars in the form of premiums. Fortunately, if unrestricted cash is given to a charity that then uses those dollars to pay premiums on a policy insuring the donor (or some other individual), the client can receive a current income tax deduction.
- Life insurance is typically a gift that will not benefit the charity until some indefinite time in the future. This is particularly true if the policy has not been assigned to or purchased and owned by the charity. Life insurance is not, therefore, the indicated means of providing for a charity desperate for cash to meet current operating expenses. Sooner or later, however, every charity that seeks to grow must think of its long-term needs. If the charity owns a permanent policy on a donor's life, it may use policy cash values and dividends as soon as they are available for any purpose.

.20 Tax Implications of Life Insurance Used to Benefit Charity. Many tax implications must be considered when making charitable gifts of life insurance, for example:

- A current income tax deduction is allowed to the extent cash or other property is transferred to a qualified charity. The client may save an amount equal to the amount of the deductible gift multiplied by the client's effective tax bracket. A $10,000 gift by a client in a 31 percent tax bracket may yield a $3,100 tax savings. This means the cost of the gift is lowered to the amount contributed less the tax savings. In this example, the gift cost is $6,900 ($10,000 — $3,100). Depending on the donor's income, the cost of the gift to charity must be further adjusted by the 3 percent reduction in itemized deductions.

- Regardless of the size of the gift, no federal gift taxes are payable on transfers to qualified charities.
- Gifts made to a charity at death including those made prior to death that for some reason were brought back into the gross estate receive an estate tax charitable deduction. This deduction is unlimited, so if a person's entire estate is left to a qualified charity, the deduction would eliminate the federal estate tax.
- No tax is paid by the charity upon receipt of either a lifetime gift or a bequest at death.
- Income earned by a charity on assets it owns is, generally, income tax free.
- When an existing life insurance policy is donated to charity, it is treated as a gift of ordinary income property in the year it is assigned absolutely to the charity. The amount of the deduction depends on the replacement cost of the policy. This depends on whether the policy in question is:

  — A newly issued policy. Typically, the deduction for a policy transferred immediately after its issue or within its first year is based on the net (gross premium less dividends, if any) premium payments made by the date of the transfer.

  — A premium paying policy. The deduction is the sum of the *interpolated terminal reserve* plus any *unearned premium* at the date of the gift. This is the unexpired premium between the date of the gift and the premium due date after the gift. Dividends accrued to the date of the gift are also added. Any loans against the policy are subtracted.

  — A paid-up or single premium policy. Deduction is based on the single premium the same insurer would charge for a policy of the same amount at the insured's attained age. If the insured is in impaired health, the donor could argue in charitable giving cases that adverse health increases the value of the gift. This argument is logical since impaired health to some extent must affect life expectancy. As of the end of 1990, however, there have been no rulings, nor is there a formal IRS position on the subject.

.21 Once a policy is donated to (or purchased on the donor's life by) the charity, subsequent premiums are deductible if paid in cash to the charity or paid directly to the insurer. However, cash payments made directly to a public charity may qualify for a deduction of up to 50 percent of the donor's adjusted gross income (AGI), whereas payments made to the insurer could be limited to 20 percent of the donor's AGI. The charity could, of course, use other money to pay premiums if the client decided to discontinue contributions.

.22 It makes no difference if premiums are paid all at once (such as in a single-premium policy) or over just a few years (such as in a *vanishing-payment arrangement*). The deduction may nevertheless be allowed in the year the donor parts with dominion and control over the cash.

.23 When to Use Life Insurance for Charitable Giving. The use of life insurance as a charitable giving tool should be considered in the following situations:

- The client would like to benefit one or more charities for reasons other than tax savings.
- The client would like to personally benefit or to benefit the family through tax savings so that the family unit has more income and capital at the same time a charity is benefitted.

3/580 ANNUITIES

Introduction

.01 An annuity is a contract that provides for the accumulation and systematic liquidation of principal and interest in the form of a series of payments for either a fixed period or an actuarially defined period, such as the life of the annuitant. In return for cash, the insurance company (or other provider of an annuity contract)* agrees to pay someone (generally, the annuitant) a stipulated sum (the annuity) periodically. Annuities are often used for life insurance payouts, retirement plan benefits, nonqualified retirement vehicles, and for estate planning purposes. (See Estate Planning Module of the *Personal Financial Planning Manual* for more information.)

The CPA'S Role

.02 The CPA's role in evaluating annuities is expanding because of the inherent nature and complexity of annuities and the need to determine the financial strength of the writer of the annuity contract. Many clients look for the objective advice of the CPA to evaluate the various annuities available from their marketers.

.03 When choosing among annuity payout alternatives, irrevocable decisions are made that will have a substantial impact on the client's financial planning. It is important for the CPA to understand the client's goals and objectives because the decisions made will affect other family members.

.04 The CPA should consider working with the client's insurance adviser to examine and understand the types of annuities and withdrawal options that are available. (See exhibits 3/500-14 and 3/500-15 for model letters that can be used to inquire about annuities.)

Types of Annuities

.05 In a straight-life annuity — the most basic form of annuity — the annuitant receives a series of payments for life, which represent principal and interest in consideration for a payment. The consideration (premium) paid for an annuity is fully earned by the writer

* For discussion purposes, it is assumed that the writer of an annuity contract is a life insurance company, unless otherwise specified.

of the contract on the death of the annuitant. Thus, in a straight-life annuity, the payments cease immediately on the death of the annuitant.

.06 Risks inherent in an annuity contract include the following:

- Loss of capital
- Loss of liquidity
- Inflation diminishing purchasing power of the lifetime payments

.07 Annuities are classified as follows:

• Method of paying premiums	- Single premium - Annual premium - Flexible premium
• Disposition of proceeds	- Single life annuity - Joint life annuity - Life with guaranteed minimum payments - Fixed period of years
• Date benefits begin	- Immediate - Deferred
• Investment of premiums	- Fixed - Variable

For descriptions of many of the annuitization options, which are similar to life insurance benefit payment options available under most annuity contracts, see ¶ 3/560.75.

Fixed-Rate Annuities

.08 Over 90 percent of all outstanding annuity contracts fall into the fixed-rate category. The annuity earns a fixed rate of interest (usually comparable to bank CD rates), which is generally guaranteed for the first one to five years of the contract. After that initial guarantee period, the rate may be set by the insurance company, depending on the rate the insurer earns on its overall portfolio, as well as the insurer's expense levels and profit margins.

.09 Most deferred annuity contracts contain a contingent deferred surrender charge (or back-end charge) if a contract is terminated in its early years. This deters annuity holders from continually moving their annuity deposits to the insurance company with the highest rate. These charges often start at 6 percent to 8 percent and decrease 1 percent per year until there are no more surrender charges.

.10 In many fixed-rate contracts, there is often a *bailout rate*. If the renewal interest rate falls below the bailout rate, the contract owner can terminate the contract without any surrender charges. The fixed-rate contract gives the contract owner no choice or say in the underlying investments.

.11 Under fixed-rate annuity contracts, the premiums and earnings of the contract are held in the general assets of the insurance company. If the insurance company becomes insolvent or fails, the contract holders are general creditors and may be unable to receive their contract proceeds in a timely fashion or in the full contracted amount. Although the insurance industry has no federal insurance to protect annuitants against failures, most states have guarantee funds that provide some measure of protection against the failure of an insurer.

.12 When comparing competing annuity contracts, it is important to look at an insurer's entire line of annuities. Many insurers offer several annuity contracts that are essentially the same in structure, except that one may offer a higher commission to the salesperson in exchange for a lower interest rate to the contract holder. The CPA may want to determine whether the salesperson is presenting the most competitive contracts, rather than the highest commission contracts. [See the Fixed Annuity Comparison Chart (exhibit 3/500-16) for a list of considerations to use when comparing annuity contracts.]

.13 Action Tips. The CPA has four actions to consider, as follows:

A. Perform a due-diligence review of the insurance companies under consideration. Deal only with insurers rated A+ by *Best* and AA or AAA by *Standard & Poor's* or *Moody's* or top rated by one of the other issuers of ratings.
B. Include a bailout provision in the annuity contract. It prevents the insurer from lowering the rate to a noncompetitive level after the initial guarantee period.
C. Avoid contracts that have heavy surrender charges. When a client's objectives change, this avoids paying high back-end load charges.
D. Ask the agent for an inventory of the various annuities the insurer writes to ensure the choice of the most competitive annuity rather than the one with the highest commission.

Variable Annuities

.14 Variable annuities differ primarily from fixed annuities because of investment flexibility. Variable annuities permit the contract holder to direct the investment of the annuity premiums into one or more classes of investments. Typically, most contracts offer a common stock fund, a long-term bond fund, and a guaranteed interest account. In addition, some contracts may offer investments such as real estate, zero-coupon bonds, and international stocks and bonds.

.15 The structure of the investments is similar to that of a mutual fund. The contract owner chooses the desired fund and receives units in that particular fund. The value of the units fluctuates, as does the value of the investments in the fund. When comparing the performance of competing annuities, it is important to determine who is actually managing the funds, because many insurers use popular mutual fund companies to manage their variable annuities.

.16 It is important to examine the expense structure inside the annuity contract, because it may be more expensive to invest in a variable annuity than mutual funds. Also, the prospective contract holder should weigh the tax benefits of an annuity against its additional costs.

.17 One important safety feature in variable annuities is that the investments are not part of the general assets of the insurer; rather, they are held in custody at a separate institution. If the insurer fails, variable-annuity holders are likely to be in a better position than fixed-annuity holders.

.18 Performance information on variable annuities is available from the following sources:

- *Financial Planning's* annual survey of variable annuities (usually appears in October)
- Lipper Analytical Services
- Variable Annuity Research & Data Service (Miami, FL)

.19 Action Tips. The CPA should give consideration to the following:

- Because the client is buying performance, look for variable annuities with a strong track record.
- Check to make sure the expense level of the favored annuity is reasonable when compared to other, similar variable annuities.
- Because variable annuities provide no protection from market risk, make sure the client's objectives match the investment objectives of the variable annuities under consideration.

Tax Implications of Annuities

.20 Cash Values. The tax-free build up within an annuity contract is allowed to *natural persons*. An annuity contract held by a *person* other than a natural person is not treated as an annuity, and the income on the contract is treated as ordinary income received or accrued by the owner during that taxable year. A corporation is not a natural person. A trust or other entity, however, if acting as the agent for a natural person, is a natural person. Exceptions to the current taxation rules are allowed for the following:

- Annuities received by the estate of a decedent at the decedent's death
- Annuities held by qualified retirement plans or in individual retirement accounts (IRAs)
- Annuities that are qualified funding assets as defined in IRC Section 130(d)
- Annuities purchased by an employer on termination of a qualified plan and held until all amounts under the plan are distributed to the employee or his or her beneficiary
- Immediate annuities, which are, briefly, single-premium annuities with a starting date within one year of purchase and equal payments made at least annually.

See IRC Section 72(u) for the rules on annuities held by other than natural persons.

.21 Annuitization: Fixed Annuities. A client's investment in an annuity is returned in equal tax-free amounts during the payment period. Any additional amount received is taxed at ordinary income rates. This means that part of each payment is considered a return *of* capital (principal) and is therefore nontaxable, and part of each payment is considered return *on* capital (income) and is therefore taxable at ordinary rates.

.22 The amount to be recovered tax free is calculated according to the *exclusion ratio*. The formula is as follows:

$$\text{Exclusion Ratio} = \frac{\text{Investment in Contract}}{\text{Annual Payments} \times \text{Life Expectancy}}$$

.23 To illustrate the exclusion ratio equation, assume a seventy-year-old person purchases an annuity for $12,000. The annuity will pay $1,200 per year for life. According to the IRS Tables, the life expectancy of a seventy-year-old person is 16.0 years; therefore, the expected return is $19,200 ($1,200 × 16). The exclusion ratio is $12,000/$19,200, or 62.5 percent. Therefore, $750 per year is income tax free.

.24 The excludable portion of any annuity payment cannot exceed the unrecovered investment in the contract (unless the annuity started before January 1, 1987). This rule limits the total amount the policy owner can exclude from income to the cost of the annuity. Once an annuitant actually lives longer than his or her actuarial life expectancy, 100 percent of each payment is taxable.

.25 Annuitization: Variable Annuities. Because the expected return under a variable annuity cannot be estimated, payments made as an annuity are not subject to the same exclusion ratio as a fixed annuity. Instead, the following formula is used:

$$\text{Exclusion Ratio} = \frac{\text{Investment in Contract}}{\text{Number of Years of Expected Return}}$$

If there is a period-certain or refund guarantee, the investment in the contract is adjusted accordingly. If payments are made for a fixed number of years without regard to life expectancy, the divisor is that fixed number of years.

.26 The exclusion ratio no longer applies once an annuitant reaches life expectancy. Therefore, if a person's actual life exceeds his or her actuarial expectancy determined when benefits began, the excluded amount (basis in the contract) is exhausted and the continuing payments are subject to tax.

.27 Death of Annuitant. When an annuitant dies before receiving the full amount guaranteed under a refund or period-certain life annuity, the balance of the guaranteed amount is not taxable income to the beneficiary (unless the amount received by the beneficiary plus the amount that had been received tax free by the annuitant exceeds the investment in the contract).

.28 If the decedent received payments under a joint and survivor annuity, the surviving annuitant excludes from income the same percentage of each payment that was excluded by the first annuitant. An income tax deduction (under IRC Section 691, income in respect of a decedent) may be available to the surviving annuitant to the extent inclusion of the annuity in the estate of the first to die generated an estate tax.

.29 If an annuitant dies before the payments received equal the cost, a loss deduction can be taken for the amount of the unrecovered investment, provided the annuity starting date was after July 1, 1986. This also applies when one person purchases an annuity on the life of another who dies prematurely. The deduction for the unrecovered investment in the contract is an itemized deduction; it is not a miscellaneous deduction subject to the 2 percent floor.

.30 Death of Deferred Annuity Holder. Amounts payable to the beneficiary of a deferred annuity contract at the death of an annuitant are taxed as ordinary income to the extent that the death benefit exceeds the total premiums paid under the contract. The cash value of the contract must either be distributed within five years of death or used within one year of death to provide a life annuity or installments payable over a period not longer than the beneficiary's life expectancy. However, if a surviving spouse is the beneficiary, the distribution requirements are applied by treating the spouse as the owner of the annuity contract.

.31 Withdrawals. If the owner of an annuity takes dividends or cash withdrawals out of an annuity contract during the accumulation phase of a deferred annuity, the amounts are taxable on a LIFO (Last In, First Out) basis, taxing income first to the extent that the policy cash value exceeds the investment in the contract. (Different rules apply to contracts purchased on or before August 13, 1982.) Under this LIFO rule, a loan is considered a cash withdrawal. Likewise, to the extent the contract is used as collateral for a loan, amounts borrowed are taxable until the amounts received equal or are less than any gain inherent in the contract. For contracts entered into after October 21, 1988, any amounts borrowed increase investment in the contract to the extent they are includable in income under these rules.

.32 In applying the interest first rule, all contracts entered into after October 21, 1988, and issued by the same company to the same policyholder during any twelve-month period are treated as one contract.

.33 In general, withdrawals from a deferred annuity made before age fifty-nine and a half are *premature distributions* and are subject not only to the normal tax on ordinary income, but also to a 10 percent penalty tax. Exceptions to the 10 percent penalty tax are allowed if the distributions are:

- Made as part of a series of substantially equal periodic payments over the life expectancy of the taxpayer or the joint life expectancies of the taxpayer and beneficiary.
- Due to the contract owner's disability.

- From qualified retirement plans and IRAs (but these are subject to other similar premature distribution requirements).
- Made to a beneficiary (or annuitant's estate) on or after the death of an annuitant.
- Under an immediate annuity contract.
- From an annuity contract purchased on the termination of certain qualified employer retirement plans and held until the employee separates from service.
- Allocable to investment in the contract before August 14, 1982.

.34 **Lifetime Gifts of Deferred Annuities.** If the annuity contract is transferred by gift, the tax deferral on the inside build up that was allowed the original contract owner is terminated. The donor of the gift is treated as having received nonannuity income in an amount equal to the excess of the cash surrender value of the contract at the time of the transfer over the investment in the contract at that time.

Action Tips

.35 The CPA should consider the following pointers when advising a client who anticipates the purchase of an annuity:*

1. The company issuing the contract: The financial strength and track record of the insurance company is of paramount importance in today's financial world.
2. Current interest rate: Important if the client chooses a fixed-dollar annuity.
3. Investment account, investment management and competitive interest, and guaranteed principal accounts: Important if the client chooses a variable annuity.
4. Guarantee period for the guaranteed interest rate.
5. Minimum guaranteed rate of interest after the initial guarantee period is complete.
6. Bailout provisions: These provisions allow the client to surrender the annuity contract without penalty if the interest rate falls below a contractually stated amount.
7. Cost of bailout provision: Determine whether the client has the option of accepting higher interest and no bailout provision or a lower initial interest with a bailout provision.
8. Interest rate track record for fixed annuities: Review investment accounts' track records and interest rate track records for variable annuities.
9. Free withdrawal privilege: Determine how much cash the client can withdraw from a contract each year without being subject to insurance company-imposed withdrawal charges: Remember withdrawal from any annuity is subject to the normal pre-age-59 1/2 penalty tax.
10. Front-end charges: Determine whether sales charges are applied against the initial deposit, which reduces your investment.
11. Surrender charges (back-end loads): Determine the percentage of the annuity that would be left with the insurance company to cover deferred sales charges if the client surrendered the annuity. At what point would such surrender charges no longer exist?

* Adapted from: Ben G. Baldwin, *The Complete Book of Insurance*, (Chicago: Probus Publishing Company, 1989), 228-229. Used with permission.

12. Waiver of surrender charges: Determine the circumstances, such as death, disability, or an annuity payout, that trigger a waiver of surrender charges.
13. Market value adjustment: Determine if on the surrender of the annuity, the surrender value is adjusted as a result of changes in prevailing interest rates. This would be typical of a variable annuity bond account. However, even though it would be a typical, it is found in some *fixed* annuities. The client would be wise to consider avoiding the latter.
14. Recovery of investment: Determine if, on surrender, the client will recover the investment in the contract in lieu of a cash surrender value provided the investment is greater; that is, the client paid more than the contract's current value. In addition, determine if the client can choose to take the payments back instead of the cash surrender value.
15. Death of the annuitant: Determine what the situation is for the named beneficiary. With a fixed annuity, it would be unusual for the beneficiary to be in a situation where the amount to be paid out was less than the amount invested. However, with a variable annuity a significant drop in the stock market could expose an individual to significant principal risk. The client may find that with most variable annuities, the beneficiary would receive the annuity at market value or the client's gross investments in the contract, whichever is greater. The client should expect to be charged approximately one-half of 1 percent for this guarantee for the variable annuity. Look for it; it does offer a measure of security.
16. Existence of annual fees: Determine what the annual fee is and its reasonableness.
17. Commission: Determine what the commission is and what its impact is on the client's account.

3/585 HEALTH INSURANCE

Introduction

.01 Health insurance provides reimbursement or direct payment for medical expenses resulting from injury or sickness. Some types of health insurance, such as health maintenance organizations (HMOs) and Blue Cross, provide direct services rather than cash reimbursements. Generally, policies distinguish between the institutional charges of a hospital for use of its facilities and a physician's charges for medical treatment. Even though a single policy may provide protection from both, it is common for it to be divided up into different sections, each providing one type of coverage. In some cases, health insurance is provided by a combination of separate specialized policies that together constitute a total coverage package.

The CPA's Role

.02 The CPA's role in evaluating health insurance is to check for the existence of adequate amounts and appropriate coverages of health insurance protection and to seek cost minimization (see exhibit 3/500-17). However, evaluation of the coverage itself is best performed by a health insurance specialist (see exhibit 3/500-18).

.03 Today's high cost of medical services makes it imperative that clients maintain the most complete health insurance coverage that they can afford. The best coverages available are usually group health insurance policies provided through employers or other entities, such as membership organizations or trade associations.

Sources of Medical Insurance Coverage

.04 **The Government.** Both the federal and state governments provide medical insurance benefits. The federal Medicare Program provides mandatory basic hospitalization benefits for most U.S. citizens over the age of sixty five and for other special classes of individuals. This coverage, referred to as Part A, is supplemented by Part B of Medicare, which is a voluntary program that provides for the payment of doctor's bills. Most CPAs recommend that eligible individuals sign up for both parts of Medicare as soon as they are entitled to them.

.05 While Medicare is insufficient by itself, it is relatively easy to provide supplemental coverage. One supplemental plan is usually sufficient. Normally, multiple supplemental plans result in wasting premium dollars, because it is rare to be able to receive more than 100 percent of the total cost incurred.

.06 Many states also offer medical insurance benefits, frequently via Medicaid, that provide medical benefits for the indigent. A number of states have also started catastrophic medical pools to provide insurance benefits for those uninsurable citizens who cannot get insurance in any other way. CPAs should familiarize themselves with the programs available in their states.

.07 The availability of medical insurance varies a great deal from locale to locale and is constantly changing. Therefore, CPAs should work with licensed medical insurance professionals who are familiar with the current market in which the client needs coverage.

.08 **Social/Association Group Insurance.** As a result of widespread concern about medical insurance, many social organizations and associations make health insurance coverage available to their membership. The insurance companies use these organizations to assist them in their marketing efforts. As a result, it is sometimes possible to obtain health insurance through membership in a local chamber of commerce, a professional organization, the American Association of Retired Persons, or a county health improvement association.

.09 The success of these plans depends on how carefully they are underwritten. There is a temptation within these organizations to offer periods of open enrollment during which members can enroll without submitting evidence of good health. When an open enrollment period becomes available in a plan, many difficult to insure clients are enrolled and, as a result, these plans experience higher than normal claims. The impact of the higher than average claims normally occurs in the third year and causes the rates to increase. When the rates increase, some of the healthier participants within the plan depart and obtain less expensive insurance elsewhere, leaving the less desirable insured in the plan. This results in even higher claims in succeeding years. This spiral continues until the rates become unacceptable to the membership, or the insurance company terminates the coverage for the group because it cannot make a profit. Consideration should be given to this weakness before recommending this type of group plan.

.10 Successful plans use good underwriting practices and maintain a population of healthy insured. It is necessary to review the history of the plan's insurance carriers and enrollment practices. An organization that continually changes insurance carriers indicates the existence of a problem.

.11 Employer-Provided Group Insurance. Employer-provided plans are available for employer designated groups and can be as small as one. Technically, however, a group containing one member is not a *group-insurance* plan.

.12 As a result of the rapidly increasing use of medical insurance plans and the increasing cost of medical care, insurance companies are asking more questions of the individual participants within an employer-provided plan before they agree to provide group insurance for the company. The underwriting is done by asking potential participants specific medical questions regarding their own situations and also by examining the medical claim experience of the group to determine if it has higher than normal claims. Thus, there are instances of insurance companies turning down groups of more than thirty individuals because one employee's spouse was pregnant.

.13 Employers should be careful when shopping for group insurance because although the insurance companies may compete vigorously for their business, the employer who accepts the plan with the lowest rate could end up as the employer with the highest rate increase in later years. Medical insurance rates have a tendency to increase. Thus, over the long run, the average rate an employer pays working with one insurance company is likely to be lower than the employer that constantly changes carriers in search of the low bid.

.14 The *switcher* risks exposing individuals within the group to loss of coverage for items the new carrier regards as preexisting conditions. The new carrier could issue a group policy with exclusionary riders that exclude a person entirely or exclude a person for a specific period of time. In short, before changing a group insurance carrier, a great deal of care is necessary.

Group vs. Individual

.15 The scope of coverage available to groups is much more comprehensive than that available to individuals. In nearly every case, the cost-benefit trade-off will justify participation in group health insurance coverage if it is available. It is not unusual for the cost of individual coverage to exceed the cost of group coverage even though the individual coverage benefits are more restrictive.

Types of Policies

.16 Insurance companies provide a wide range of health insurance coverages. Most non-Blue Cross/Blue Shield and HMO coverages are provided on a reimbursement basis. That is, they reimburse the insured for specified medical care or treatment subject to policy limitations. There are a number of insurance coverages available that provide prespecified daily benefits for hospitalization or while afflicted with specific sicknesses. These policies are of questionable value. It is important to consider the advantages of a comprehensive major medical policy. Having a combination of limited benefit policies could result in too many gaps and little if any protection against catastrophic loss.

.17 Major Medical Policies. The most comprehensive policies provide unlimited benefits on both a per-occurrence and aggregate measure. Recent problems in the health care arena have prompted many insurance companies to cut back from unlimited coverage and to impose aggregate lifetime limitations of one million or less. In 1991, the desired quality coverage should provide maximum benefit limitations of at least $1 million.

.18 *Deductibles* — Deductibles provide that all initial medical expenses, up to a specified amount, be paid for by the insured. After the deductible has been satisfied by the insured, the insurance company begins to pay claims. There are three approaches to deductibles under a major medical policy: (1) per-occurrence, (2) per-individual insured, or (3) per-family unit covered. A per-occurrence deductible with a high stated dollar amount would result in the lowest premium for otherwise equivalent coverage. Of course, the other side of this is that the insured would have the greatest out-of-pocket expense for deductibles under the per-occurrence basis. Deductibles applied on a per-individual basis or a per-family basis specify a time period in which this deductible must be satisfied, such as a policy year or a calendar year. The per-individual type of deductible is sometimes provided with a family maximum per year such as three or five times the per-individual deductible. For example, a family of five with a three-times per-individual deductible family limit and a $200 per-individual deductible could sustain up to $600 in deductibles during a year. But the family would have no deductible applicable to benefit claims for the fourth and fifth family member during that same year. A per-family deductible provides the most predictable deductible expense for the insured.

.19 After the deductible has been satisfied, benefits are payable under these policies. The first layer of these benefits payable is almost always subject to a coinsurance provision. Thus, the insurance company pays less than 100 percent of the cost; 80 percent is a common coinsurance factor. The insured is responsible for the remaining portion of benefits in this first layer of coverage. Policies that have only one layer and require the insurer to share a percentage, such as 20 percent of all expenses without limit, should be considered unacceptable.

.20 *Stop Loss Provisions* — The stop loss provisions of major medical policies establish the upper bounds on the first layer of coverage at which the insurance company pays less than 100 percent of the expenses. Once the losses exceed the stop-loss limit, the insurance company pays 100 percent of the expenses and the insured is not responsible for any co-payment. One exception to this is expenses that exceed the internal policy limits per procedure.

.21 Stop-loss limits can be specified in two different ways:

A. The insurer specifies the aggregate covered expenses that must be sustained before 100 percent benefits become payable.
B. The insurer specifies the maximum dollar amount of co-payment expenses the insured may sustain before the insurance company pays 100 percent of covered expenses.

.22 *Other Policy Limits* — Insurance company expense experience under major medical policies necessitated internal policy limits for specified procedures. To prevent price gouging by health care providers, major medical policies specify the maximum benefit that is payable for a list of standard procedures. A different limitation is set forth for each listed procedure and generally is a binding limitation on benefits unless there are complications that justify exceeding the limit.

.23 *Exclusion Limits* — The quickest way to check a major medical policy to see if it provides comprehensive coverage is to review the exclusion section: the section of the contract specifying what is not covered. Commonly, there is no coverage for losses sustained as a result of self-inflicted injuries, military service, cosmetic surgery, losses covered under workers' compensation, or losses covered by a government program, such as care and treatment in a Veterans Administration hospital for eligible veterans of the military service. Exclusion provisions that are more encompassing than these are a good indication of less than adequate coverage.

.24 **Indemnity Plans.** Blue Cross/Blue Shield provide significant amounts of health insurance, and very often the insurance is provided on a service basis rather than on an indemnity or reimbursement basis. Blue Cross/Blue Shield plans often differ significantly from one Blue Cross/Blue Shield carrier to another. Each separate organization decides independently on the exact provisions of its coverage. Under nearly every one of these plans, the Blue Cross/Blue Shield organization has obtained agreements for discounted prices from participating service providers, that is, hospitals and physicians. To get maximum benefits from the plan, the insured individual must use the participating providers. Greater restrictions apply to services obtained from nonparticipating providers.

.25 Medical care or services provided by nearly all licensed hospitals and many licensed physicians are covered to the full extent of these policies.

.26 **Health Maintenance Organizations (HMOs).** Health Maintenance Organizations (HMOs) provide very complete and extensive medical care services on a prepaid basis to their subscribers. These services must be provided by participating physicians at participating facilities except on an emergency basis. HMOs provide more extensive preventive medicine services, such as prior examination and nutrition training. They also rely very heavily on a primary physician to provide gatekeeper control over care and treatment by specialists.

.27 Services are usually provided without any aggregate or maximum limitations on benefits and without any deductibles or co-payment provisions. There is usually a nominal fee charged for a visit to the primary physician.

.28 HMOs usually do not allow individuals to obtain individual coverage unless it is a conversion of group coverage on termination of employment with the covered group. HMOs primarily market their coverage as a group benefit provided through employers.

.29 **Preferred Provider Organizations (PPOs).** In an effort to contain costs of benefits under major medical policies, some employers have entered into agreements with the insurance company to encourage the insured individuals under the plan to seek care from low-cost providers. A stimulus is usually provided in the form of lower deductibles or lower co-payment percentages applicable when medical care is supplied by a preferred provider. Each insured is supplied with a list of physicians and facilities to use to gain the more generous benefits. These arrangements are often called preferred provider organizations (PPOs) because there is usually an administrative organization that negotiates a discounted price for the services of the participating institutions and individuals.

.30 So far, the benefits from the PPOs have been short lived. Initially the savings are significant, but with success comes rapid growth and a diminished ability to provide services at a below-average cost.

.31 **Self-Insurance.** Some employers, usually large ones, self-insure medical benefits for their employees. They often obtain outside stop-loss coverage for catastrophic exposure. This coverage from an insurance company has a large deductible that sets the upper limit of the employer's direct responsibility. Insurance companies also provide, when desired, the administrative services for handling claims under self-insured plans.

Limitations on Health Insurance

.32 **Nonduplication of Payments and Coordination of Benefits.** To prevent duplicative coverage, a standard provision specifies that benefits will not be paid for amounts reimbursed by other insurance companies. Thus, the total benefit payable is limited to 100 percent of covered expenses.

.33 **Preexisting Conditions.** A preexisting condition is an illness or ailment the insured had before being covered under the current contract. Because health benefits may not be paid for a preexisting condition for a specified period of time or not at all after the contract begins, care should be exercised when there is a change in carrier to assure there is no gap created in health coverage.

.34 **Continuation of Coverage After Employment.** A federal law enacted in 1986, the Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA), and applicable to employers who provide health benefits to twenty or more employees requires the employer to permit terminated employees to participate in the group insurance plan for up to eighteen months after termination. The former employee is required to pay a premium for this extension of coverage. Also, COBRA provides that, under some circumstances, spouses and children of the ex-employee may be entitled to as much as thirty-six months of continued health insurance coverage.

.35 At the end of the mandatory COBRA extension, employees may have the right to convert the group coverage to an individual policy without having to show evidence of insurability. This is a valuable right for individuals who are in poor health and cannot obtain new policies on an individual basis. The coverage available through conversion is often more expensive and less generous in benefits than coverage that healthy individuals could obtain by purchasing a new policy.

.36 Unless an employer provides ongoing health coverage during retirement, retirement often presents the employee with the need to obtain individual major medical coverage. Retirees, regardless of age at retirement, are eligible for Medicare coverage on reaching age of sixty-five. Adequate medical coverage beyond age sixty-five is accomplished through a combination of both Parts A and B of Medicare and a Medicare supplement policy (Medigap) from a private insurance company. Medigap policies pay items of expense and deductibles not covered by the basic Medicare coverages. Unfortunately, neither Medicare nor Medigap policies provide protection for nursing home stays for custodial care.

Tax Implications of Health Insurance

.37 Among the tax implications of health insurance are the following:

- An employer's premium payments for employee health benefits are a deductible business expense.
- An employer's premium payments for employee health benefits are not taxable income to the employee.
- Benefits payable under an employer-financed accident or sickness plan that are not wage-continuation payments are excluded from an employee's gross income for federal income tax purposes.

3/590 LONG-TERM-CARE INSURANCE

Introduction

.01 Long-term-care insurance policies provide a stated dollar benefit per day when an individual is institutionalized in a nursing home or other acceptable facility for custodial care for a chronic condition. Policies also can provide home care benefits to insured individuals unable to perform a specified list of activities for daily living at levels equal to

50 percent or more of that available for institutional care. Long-term-care policies are in a state of flux, and rapid changes in coverage can be expected for many years to come.

.02 Clients over age sixty-five are the primary market for this coverage. The policies can be issued at an age as low as eighteen and provide protection not available from any other type of coverage for the long-term care of chronic conditions following injury or sickness.

The CPA's Role

.03 The CPA's role in evaluating long-term care is to advise clients of the importance of obtaining catastrophic protection. (See exhibit 3/500-19 for a model letter to use to obtain long-term care information.) Consideration should be given to the significant premium reduction for longer elimination periods.

.04 In addition to protecting the client, the CPA should consider recommending that the client protect potential dependents, for example, parents, children, other relatives.

The Policy

.05 Benefits. Long-term-care insurance policies provide a stipulated dollar amount of benefits per day when the insured meets the qualifications for eligibility. The insured selects the level of benefits at the time of initial purchase and pays the appropriate premium for that benefit. The benefit is often sold in increments of $10 per day. Thus, for example, the purchase of twenty units would provide $200 per day in benefits. The benefit amount is subject to upper limits imposed by the insurance company. In 1991, the upper limits imposed by many insurance companies were either $150 or $200 per day. The full benefit is payable while the insured receives custodial care, intermediate care, or skilled nursing care in an nursing facility.

.06 One-half the stated daily benefit is usually available when the insured needs home care to carry out some of the activities of daily living. Policies specify that benefits are payable when a specified number, such as three, four, or five, of the activities for daily living specified in the contract cannot be performed by the insured. Activities for daily living generally include eating, walking, bathing, toileting, standing, dressing, sitting, and transportation.

.07 The benefits are payable directly to the insured and are generally not a form of reimbursement. It is most likely that the benefits will be used by the insured to pay for nursing care or home care. However, the insured could use the benefit money for whatever purpose desired.

.08 Long-term-care insurance policies differ in terms of the length of benefit period they provide. Some insurers offer purchasers a choice of the length of the benefit period. Although a few insurers provide a benefit period of only twelve months, it is more common to find benefit periods of two or three years. Higher quality policies provide benefit periods of at least four to six years; unlimited benefits are available from some insurance companies.

.09 Short benefits period limitations on policies are a problem because of the threat to an insured's assets coming from a long-term stay in a nursing care facility. While long-term stays are infrequent, they are devastating when they do occur.

.10 Waiting Periods. Some long-term care policies are available with a zero-day waiting period so that benefit payments start on the first day in a nursing home or the first day the insured is unable to perform the necessary number of activities for daily living. It is much more common to have a waiting period of thirty days or longer before benefits begin. Many companies offer two or more choices among available waiting periods. Obviously, the longer the waiting period the more significant the premium reduction. Insurance companies often provide waiting periods of 30, 60, 90, 100, 120, and 180 days, and sometimes even longer. Shortening the waiting period could increase the benefits payable for any given length of stay or care or the number of stays or care that qualifies for benefits. However, this extension of coverage is not nearly as important as protection from potentially devastating long-term stays.

.11 Premiums. Premiums for long-term-care insurance depend on the age of the insured when the coverage is initially purchased. Premiums are level for the remainder of the policy and are only increased in the future on a class basis. Thus, an insurance company cannot raise the premium for any one insured without raising it for all other insureds under the same classification of coverage.

.12 The coverage is written for insureds between the ages of eighteen and eighty-five on a group or individual basis. Most policies purchased on an individual basis are issued at ages sixty-five and above. At that age it usually takes at least $1,000 in annual premium to provide $100 in daily benefits for nursing home stays and $50 per day in benefits for home care. There is a larger escalation in premiums after age sixty-five than for younger ages. Thus, in 1991, similar coverage purchased at age eighty-four had an $8,000 annual premium. Comparable coverage purchased at age forty-five had a premium of under $400 annually. The premium differential for different length elimination periods or waiting periods also escalates with original issue age. Under one company's 1991 premium schedule, lengthening the elimination period from zero days to 100 days at age fifty-four reduced premiums by $200 annually. That same company would reduce premiums over $600 annually for going from a zero-day waiting period to a 100-day waiting period for individuals age sixty-five.

.13 Renewability. At a minimum, a long-term care policy should be guaranteed renewable for life. This provision prevents the insurance company from canceling the coverage as long as the premiums are paid.

.14 Coverage Limitations. Long-term-care insurance policies should optionally provide benefits without requiring periods of prior hospitalization or periods of prior care at a higher level of intensity than that for which the benefits are paid. For example, some of the lower quality policies provide benefits only after a hospital stay of three or five days immediately prior to admission to a nursing care facility.

.15 Other policies specify levels of care within a nursing facility, such as skilled nursing care, intermediate care, and custodial care, and then require that the insured receive a specified number of days of skilled nursing care before benefits are payable for intermediate care or custodial care. Similarly, these policies would provide only custodial benefits after an individual received intermediate care for a specified number of days immediately preceding the custodial care. These restrictions should be considered unacceptable for long-term care policies because they would preclude benefit payments in cases that are all too common. For example, an individual could enter a nursing care facility for purposes of custodial care without any prior period of hospital care or more intensive nursing care.

.16 A policy is unacceptable if it excludes benefits for Alzheimer's disease or other organic brain disorders. The better quality policies available provide adequate coverage for these conditions. The better quality policies also provide home care benefits automatically without any premium surcharge for the benefit period.

.17 Tax Implications of Long-Term-Care Insurance. Premium payments for long-term-care insurance policies are not deductible by employers or individuals. At this time, the tax treatment of benefits is not clear. The IRS could argue that the benefits are taxable income. Policies providing acceptable levels of benefits tend to go beyond the Internal Revenue Code accident and health provisions that provide exemption from income taxes.

.18 Considerations for Long-Term-Care Insurance. The CPA has five considerations when advising clients on long-term-care policies. These are:

A. Long-term-care policies provide asset protection for those whose income or assets preclude them from Medicaid payment of their nursing home bills.

B. Giving assets to family members on admission to a nursing home to qualify for Medicaid benefits after a stay of more than thirty months. Federal law permits recovery of assets disposed of at less than fair-market value in the thirty months prior to Medicaid eligibility.

C. Because protection against long-term stays in a nursing home is more important than first-dollar coverage or short waiting periods, clients can obtain longer deductibles or waiting periods and a benefit period of at least four years, or the ideal — lifetime.

D. Long-term care policies available in 1991 are much improved over those available a few years ago. If the insurance company has not taken steps to liberalize an older policy, the company may at the client's request upgrade coverage. If upgraded coverage is unavailable, it may be necessary to replace the existing policy with newer, more complete coverage from another carrier.

E. Top quality policies for long-term care require a complete evaluation of a client's medical condition. The client should avoid companies willing to issue a long-term care policy on the basis of little or no medical information because of the high likelihood that they may do the major portion of their screening when a claim is presented. As in other forms of insurance, better protection is generally available from companies that correctly assess the risk at the time of issuance and charge an adequate premium to provide the anticipated benefits.

Medicaid

.19 For individuals unable to obtain long-term care policies due to health or financial constraints, Medicaid may provide an alternative. The idea of transferring assets or spending down to qualify for Medicaid has come about as a result of the Medicaid programs that provide long-term care support for people without assets. Statistics show that a majority of the people who require care in a nursing home exhaust all of their own resources paying for care by the end of two years and then become dependent on the state.

.20 Medicaid legislation passed in November 1989 was designed to protect the spouse of a nursing home resident from becoming impoverished. This legislation affects older persons with low incomes and modest assets. Although there are variations from state to state, generally, to qualify, a patient must show extreme financial need. That means the assets of both spouses must be nearly exhausted for one to be eligible. Before a client implements a financial strategy based on the new law, it might be advisable to retain legal counsel in the state of residence with expertise in Medicaid matters.

.21 Income Requirements. The spouse of a nursing home patient is entitled to a monthly maintenance needs allowance from the income of that nursing home patient. The amount of this allowance is individually determined and based on the objective of raising the at-home spouse's income to the amount specified under the federal laws, which is indexed for inflation.

.22 An at-home spouse could also be entitled to a *shelter allowance*, which would be added to the monthly maintenance needs allowance if total housing costs (defined as mortgage, taxes, insurance, and utilities), exceed 30 percent of the maintenance allowance. The states can increase this figure, but the federal law caps it at $1,500 per month, indexed for inflation. These allowances can be raised by court order or through the Medicaid appeal process in each state.

.23 Asset Requirements. If a spouse enters a nursing home after September 30, 1989, the local Medicaid agency can conduct an assessment of the couple's combined assets, including all countable assets regardless of source or ownership.

.24 Significant assets that are excluded from this assessment include:

- A home, as long as the spouse or certain specified individuals, such as a dependent child, reside in it
- One car
- A burial fund for each spouse, the amount of which is set by the state

The other assets that are part of the assessment may then be divided in an equitable, although not necessarily equal, manner between the spouses.

.25 The at-home spouse can retain the greater of $12,000, or one-half of the assessment assets, but not more than $62,500 for 1990 (indexed annually for inflation). This resource allowance can be increased by court order or through the state Medicaid appeal process. Once this division of resources takes place, the spouse confined in the nursing home will use any resources until they are exhausted.

.26 Transfer of Assets. The key to success in transferring assets to spend down to Medicaid is to make the transfers more than thirty months prior to applying for Medicaid. Clients need to obtain the advice of counsel familiar with Medicaid to assure effective transfers for Medicaid purposes.

.27 Legislative proposals have been designed to curb abuse of the transfer rules. Until the law becomes settled, clients should seek legal counsel when planning for long-term care financed by Medicaid.

.28 Action Tips. The following actions can help a client qualify for Medicaid:

- Turn a nonprotected asset into a protected one by buying a protected annuity with nonprotected investment assets for the at-home spouse.
- Transfer the family home to a qualified relative, such as:
    - A spouse
    - A child who has provided care to the Medicaid applicant for two years or more
    - A minor, blind, or disabled child
    - A sibling who owns part of the home and has lived in it for a year immediately before the Medicaid applicant moves to the nursing home
- Pay off any home mortgage to turn nonqualifying assets (cash) into qualifying assets (equity in the home) and simultaneously relieve the at-home spouse's expense burden.
- Improve the home or make additions that enhance market value: a shift from nonqualifying to qualifying assets.
- Use the nursing home resident's assets to purchase a home for the at-home spouse.

All of these actions have major tax (income, estate, and gift) and personal implications that must be measured against the benefits they provide.

3/595 DISABILITY INCOME INSURANCE

Introduction

.01 Disability income insurance is a form of health insurance that provides an individual with replacement of a percentage of lost earned income due to a physical or mental incapacity. Disability income insurance is needed whenever ongoing living and medical expenses may exceed income from client's investments, spouse's income, and existing earned income replacement provisions. Most clients need disability income insurance because fewer than one in six have adequate income protection.

The CPA's Role

.02 The CPA's role in evaluating disability income insurance is to inform clients of the need for disability coverage and the appropriate protection levels and to specify minimum quality standards for the coverage. (See exhibits 3/500-20 to 3/500-22.) The CPA should also consider making sure the client understands that if the premiums are paid by employers with before tax dollars the benefits are taxable. Many CPAs recommend that the employee pay the premium so that benefits are federal tax free.

How Much Disability Income Insurance Is Enough?

.03 Many methods are used to determine how much disability income insurance a client should consider. The commonly used method is *disability-income programming*. In disability-income programming, the CPA totals the expenses that are expected to continue during disability and compares them to the various benefits available to the client. (See exhibit 3/500-23.) Under this method, the difference between the two is the amount of disability income insurance the client needs. However, the potential for underestimating expenses and overestimating sources of income is very high.

.04 A safer method of determining the amount of disability income insurance a client needs is to apply to an insurance company and request a policy for the maximum coverage it will underwrite. An underwriting rule of thumb used is that benefits will be limited to 60 percent of predisability monthly earned income.

.05 The insurance company will ask for information regarding all of the client's current sources of income and all potential sources of income during disability, including investment income and group and association disability benefits. Based on this information, the insurance company will determine the limit of coverage that it will provide. The insurance company could also determine if the prospective insured's sources of income during disability are subject to income tax. Someone receiving nontaxable disability payments of 70 percent of earned income may not be economically motivated to return to work.

.06 A client should purchase the maximum disability insurance that the insurance company allows. If a client is ever disabled and drawing benefits, it is unlikely the CPA will be criticized if those benefits are too high, but very likely the CPA will be criticized for benefits that are too low.

Evaluating Disability Income Insurance Policies

.07 The following information is pertinent to the evaluation of a disability policy for a client.

.08 **Occupation.** Many occupations are not eligible for disability insurance. This is especially true for occupations involving some degree of physical labor or hazardous conditions. For example, it is nearly impossible to find disability income coverage for fire fighters, construction workers, or undertakers who do embalming. For these individuals, poor quality coverage is all they can get. However, poor quality coverage is better than no coverage.

.09 **Definition of Disability.** The basic disability income policy provides benefits when the insured is totally disabled. Those benefits cease when the insured has recovered enough to no longer qualify for benefits.

.10 If a client is engaged in an occupation for which his or her *own occupation* or *regular occupation* can be insured, it should be considered the preferable coverage. This type of coverage provides benefits, for example, to the surgeon who can no longer perform surgery but could still practice medicine. Some insurance companies do not provide *own-occupation* disability coverage at all. Those insurers that do make it available limit the eligible occupational categories covered.

.11 An unacceptable definition of disability is one that provides benefits when the insured is unable, due to injury or sickness, to perform the substantial and material duties of any occupation for which he or she is reasonably qualified by reason of training, education, or experience. This is often referred to as the *reasonable-occupation* or *any-occupation* definition. Any-occupation policies are very restrictive and must be avoided unless that is the only type of coverage available because of the client's occupation or health.

.12 Some policies provide an *own-occupation* definition for a limited period, such as two or three years, and then apply a *reasonable-occupation* definition for further benefits. The insurer expects the insured to change occupations if unable to recover in the specified time period.

.13 **Partial Disability or Residual Disability.** Many recoveries are slow and gradual. Recognizing this, insurers have developed two approaches to continuing a lower level of benefit payments during the recovery or partial disability phase of *own-occupation* policies. Partial disability is defined as the inability to perform one or more important duties of the insured's job.

.14 The first approach provides partial disability benefits for insureds with predefined physical limitations on their activities. This type of coverage specifies various levels of benefits payable for different specified levels of impairments or restrictions such as 50 percent of the total disability benefit for the loss of use of one hand. It is defined as the inability to perform one or more important duties of the insured's job.

.15 The other approach is to provide benefits to replace lost income rather than focusing on the physical aspects of the disability. These policies provide residual disability benefits when the insured is still disabled but able to work and earn less than 80 percent of predisability income. These benefits are tied proportionately to actual earnings lost, regardless of occupation. When residual disability benefits were first introduced, a prior period of total disability, called a qualification period, was required. Some policies are now available with a zero-day qualification period, which means income replacement benefits can be paid without suffering a total disability. An example is the surgeon whose arthritis forces a cutback in the procedures performed. The benefit payable is a fraction of the total disability amount, that is, lost income divided by the predisability income.

.16 Renewability. A contract that gives the policy owner the right to continue coverage by the timely payment of premiums, and the insurer no right to make any changes in the contract except for specified premium adjustments, is *guaranteed renewable*. Generally, under a guaranteed renewable policy, the company cannot increase the rate for a single individual, but only for an entire class. Guaranteed renewable coverage is appropriate for individuals who are sixty five or who are still working. Policies that are conditionally or collectively renewable are unacceptable, unless a health or occupation limitation makes better quality policies unavailable.

.17 Noncancelable. A noncancelable policy contains a continuous contract guarantee that the company cannot cancel or modify the policy in any way, even if the company has had bad claims experiences, or if it finds out the policyholder's health has declined. This type of contract is continued at the option of the insured. Clients should seek noncancelable coverage whenever possible.

Duration of Benefits

.18 A policy specifies the benefit period or maximum duration of benefits for any one disability. In an acceptable policy, this period should extend at least to age sixty-five for both injury and sickness. Some policies impose a shorter benefit period for disabilities stemming from sickness; they are unacceptable for healthy clients.

.19 Persons who plan on working beyond age sixty-five need policies that pay benefits beyond that age. Some insurers provide lifetime benefits for a limited number of occupations. The availability and cost-benefit trade-off should be evaluated for each individual case.

.20 Disability income policies are available for benefit periods of two, three, or five years at significant premium savings over those providing benefits to age sixty-five. These policies are less than complete protection because they could terminate benefits during long-term disabilities. Although these policies are less than optimal, they do provide adequate protection for the most frequent short-term disabilities. In some cases, they are the only policies available to a particular individual.

Elimination or Waiting Period

.21 Disability income policies specify a period of time after the onset of a disability before benefit payments start. This is known as the waiting period or the elimination period. Most insurers provide a choice among many options, such as 30, 60, 90, 120, 180, or 365 days. The longer the waiting period, the lower the premium (with all other factors remaining constant).

.22 Often the ninety-day waiting period is considered optimal. It is important to note that insurers pay benefits at the end of each month of eligibility so that a policy with a sixty-day waiting period provides the first benefit payment ninety days after the onset of disability.

.23 Waiting periods must be selected on the basis of ability to meet cash flow needs prior to the first benefit payment. This may take into consideration salary continuation benefits from the employer, state benefits (California, Hawaii, New Jersey, New York, Rhode Island), and emergency funds held by the client. The waiting period should not be so long that it presents a client with a serious cash flow problem.

Recurrent Disability

.24 On certain policies, recurrent disabilities are paid without having to satisfy the elimination period requirement again.

Optional Coverages

.25 **Cost-of-Living Adjustments.** The base disability income policy usually has no inflation-protection provision. However, many companies offer an optional additional benefit, a cost-of-living adjustment rider. This rider provides:

- Automatic upward adjustments of benefit payments for inflation while an individual is disabled.
- Adjustments that can be either a stated percentage or a consumer price index-based adjustment.
- Adjustments are made on a simple interest basis or a compound interest basis.

Some insurance companies offer a wide range of adjustment bases from which to choose. There is usually an annual cap on adjustments and an aggregate cap, that prevent benefits from rising above twice the original amount of benefit.

.26 **Guaranteed Insurability Rider.** A guaranteed insurability rider guarantees the right to purchase increased insurance even though health has deteriorated. Under the rider, an individual may purchase additional disability coverage up to a specified amount based on the insured's level of income even if the insured is in poor health. This rider is available at an additional premium.

.27 **Exclusions.** A disability policy may have certain exclusions, such as war, self-inflicted injury, or acting as a pilot-crewmember of an aircraft.

.28 Accidental Death and Dismemberment. A policy may have a benefit for accidental loss of one or more bodily parts such as hands, feet, and eyes. Many CPAs think that the client's money would be better spent elsewhere.

.29 Waiver of Premium. A waiver of premium rider exempts the insured from paying premiums during periods of total disability. This is an available rider on guaranteed renewable and noncancelable individual disability income policies.

.30 Elective Indemnity. An elective indemnity provision in a policy enables the insured to elect to receive a lump-sum benefit in lieu of periodic disability benefits. Electing a lump-sum benefit is *not* always in the client's best interest. The CPA should attempt to determine through reasonable projections the best course for the client.

Premium Basis

.31 Disability income policies are usually sold in increments of $100 of benefits per month. The insured purchases as many incremental units as desired subject to insurance company limits on the amount of coverage available. Insurance companies, when setting maximum policy benefit limits, take into consideration the income, the individual's occupation, as well as other sources of disability benefits the individual has. The premiums for these incremental benefit elements are based on age and sex. Sex-based premiums result in higher premiums for women than for men. Some companies, however, are now offering unisex rates.

.32 Premiums increase with age at the time of, but for any purchased policy the premiums are generally level for the remainder of the life of the contract. If future premium levels are not guaranteed, such as in noncancelable policies, there is the possibility that the insurance company may increase premiums. However, this is not likely to be a frequent occurrence and may not occur at all.

.33 For example, under one company's policy, which uses unisex rates, a forty-five year-old individual can purchase a long-term disability policy to age sixty-five at a price of $49.50 per $100 of monthly disability benefit. That premium is an annual premium for the monthly benefit and is multiplied by the number of units purchased. Then a policy fee is added — $15 for the company in this example (but policy fees can be as high as $50). Cost-of-living adjustments are priced in a similar manner based on the level of adjustment. The policy has an optional rider providing a 3 percent compound annual adjustment while the insured is disabled for $6.40 annually for each $100 increment of monthly benefits. The total annual premium for this policy to provide $2,000 in monthly benefits would be $1,133. That is, twenty units of base protection ($2,000/100 × $49.50 = $990) plus twenty units of 3 percent inflation protection ($2,000/100 × $6.40 = $128) plus a $15 annual policy fee ($990 + 128 + 15 = $1,133). The rates in this example are for a low-risk professional classification. Rates differ widely among the insurable occupations and companies.

Social Security Disability Benefits

.34 Generally, a client should not depend on Social Security for disability benefits. The definition of disability under Social Security is very narrow. In addition, the disability must be expected to last at least one year, the insured must not be able to do any job, and the cause of disability must be likely to result in death. In addition, Social Security approval rates and continuation of payments are subject to political pressures. For example, during the period from October 1981 until July 1983, as a result of the budget crunch, some 314,000 existing disability cases were reviewed, and in 142,000, or 45 percent, of them, benefits were terminated. In a number of cases, however, the termination of benefits was reversed. It is not prudent to allow a client's benefits to depend on such an uncertain process.

Other Statutory Programs

.35 There are a number of legally required income replacement plans that serve the needs of a CPA's clients. All states have enacted workers' compensation laws, which impose absolute liability on an employer for specified injuries suffered by employees in the course of their work. Workers' compensation provides payments to injured workers for loss of income, medical expenses, and rehabilitation. Some states have established second-injury funds, which provide payment to compensate workers who suffer a second disabling industrial injury. The existence of these funds makes it practical for an employer to hire disabled workers without being exposed to an unacceptable liability. Puerto Rico and California, Hawaii, New Jersey, New York, and Rhode Island have established compulsory temporary disability plans that provide income to workers disabled from *nonoccupational* causes. These plans furnish compulsory complementary coverage to the workers' compensation laws that cover occupational disabilities.

.36 As with most legally required programs, these coverages provide a base on which to build a client's total income replacement plan. There is not a great deal that CPAs can do about these legally required programs other than to be aware of their existence.

Group Insurance and Association Group Plans

.37 **Employer-Provided Group Disability Income Insurance.** When a client has an employer-provided group disability income insurance plan, there is little flexibility about the plan benefits or costs. Therefore, the balance of the client's disability income insurance must be designed around the group-provided plan benefits. There are both advantages and disadvantages to group disability income insurance plans.

.38 **Advantages of Group Disability Insurance.** Group disability income insurance can be short term or long term. Short-term benefits usually last for a period of up to twenty-six weeks and is coordinated with any individually purchased disability income insurance so that the long-term policies start paying benefits after the short-term disability income insurance benefits have terminated; this results in a premium savings. A long-term disability income plan usually provides maximum payments of 50 to 70 percent of the employee's salary to at least age sixty-five. The benefits are usually capped at some stated maximum so that high-salaried executives frequently receive a good deal less than the 50 to 70 percent. The primary advantage of group disability income insurance is that coverage usually is relatively inexpensive.

.39 Disadvantages of Employer-Provided Group Disability Insurance. Employer-provided disability insurance has a large number of weaknesses including:

- restrictions on the maximum benefit;
- weak definitions of disability;
- possible integration of the benefits with Social Security or other sources of disability income benefits.
- If a termination of employment there typically is no quality-conversion privilege to an individual plan.
- No assurance that benefits will be available when needed.
- Coverage by a group plan also limits the client's ability to purchase individual insurance while employed because of the total cap on earned income that a carrier imposes.

The client may be required to find an individual plan at a time when it may not be feasible to purchase the coverage because of economic or health reasons. This is particularly troublesome for someone who is leaving current employment to become self-employed. Obtaining new disability insurance coverage may be difficult because there may not be an established income level from self-employment or history of business income or profits.

.40 Association Group Disability Income Insurance. Association-offered group insurance plans are available. These plans are attractive because of their low cost. However, they frequently are inadequate because of weak definitions of disability, limited benefit periods, and the right of the group carrier or the association to terminate the plan at will. This leaves the insured with the need to replace the benefits at what could be an inopportune time. For example, one association has a plan in which the rates increase every ten years and are not guaranteed. The plan's definition of disability is *own occupation* only for the first five years of disability. Many of the association's members qualify for better coverage than this on an individual basis.

.41 Tax Implications of Group Disability Insurance. If a C corporation employer pays for disability coverage for its employees, the disability income benefits payable to those employees are taxable on receipt. In most cases, this would be a situation to avoid if possible. It may make better sense to have the employees pay for the disability income protection provided so that when benefits are received they are not taxable income. A planning opportunity exists for a corporate employer that requires a contribution from its employees for various employee benefits and that does not allocate the contribution to any particular benefit. If the employer's in-house administrative practices are changed to allocate the employees' payments to the premiums for the disability income coverage, it is possible to eliminate ordinary income taxation on any disability benefits paid.

Business Overhead Expense Disability Income Insurance

.42 In many cases, a client's disability does not cause the operating expenses of the office to cease. Overhead disability income insurance policies are issued for this specific purpose. They normally have a very short waiting period and relatively short payment period. The premium payer is normally the business, and the business deducts those premiums as a normal business expense. If benefits become payable, they are taxable income to the business but are offset by the fact that they are then used to pay the normal business expenses. This is an essential coverage for those clients, such as personal service professionals (doctors, lawyers, CPAs, and the like), who have no other means of making sure their office operation continues to run smoothly during a period of temporary disability.

Business Buy-Out Disability Income Insurance

.43 Business buy-sell agreements funded with life insurance that take effect on the death of one of the business owners are common. It is relatively easy to plan what could happen in the event of a death and to fund those plans via life insurance. It is more difficult to set up arrangements providing for a buy-out of a business owner's interest in a business in the event of disability.

.44 The most important issues to be resolved are: When is the buy-out to take place; and how long can the business owner be disabled before the provisions of a mandatory buy-sell agreement become effective to terminate that shareholder's ownership in the business. These are essential questions to consider and difficult questions to answer.

.45 No business owners want to see their business interests terminated while they still have hope of returning to active participation. As a result, most disability income buy-sell agreement policies are issued with long waiting periods of either twelve to twenty-four months. If, at the end of the waiting period, the insured is still disabled, then the benefits become payable.

.46 Although a lump-sum payout is normally desirable, it may be difficult to obtain from an insurance company. The maximum lump sum coverage currently available is between $500,000 and $1,000,000 and is payable only for full redemption of the disabled owner's business interest. The insurance underwriting for disability buy-sell agreements is usually carefully done with consideration given to the financial reasons for the agreement as well as the health status of the potential insured.

Action Tips

.47 The CPA should consider the following points for possible action:

- Disability income coverage that is both guaranteed renewable and noncancelable (guaranteeing that the premium payments cannot be increased during the life of the contract) to age sixty-five.
- Benefits provided should be high enough to replace earned after-tax income.
- To obtain maximum amounts of coverage, have the client purchase an individual policy before acquiring group coverage through professional associations or other sources.
- Coverage is difficult to obtain for individuals in high-risk occupations or with health problems. Therefore, seek brokers specializing in disability coverage who may be able to obtain at least part of the needed coverage.
- If less than maximum coverage is purchased, the client should buy cost-of-living-adjustment and other benefit-enhancing riders in addition to base policy coverages.
- Make sure that a client's short-term and long-term coverages do not overlap.
- If a client is a controlling employee of a corporation, suggest that disability income insurance premium be paid by the employee and the corporation so that if the client is disabled, there is enough taxable income from policy benefits to offset deductions in the 15 percent tax bracket.
- Coordinate benefits from any individual policies with group benefit packages. The client may wish to purchase a disability income insurance policy with a sixty-day elimination period, if a group policy has a sixty-day short-term benefit.
- Review the insurance coverages by taking an inventory of the coverages.

3/5100 HOMEOWNERS INSURANCE

Introduction

.01 Homeowners insurance covers, in a single policy, a variety of risks including physical damage to property and theft of personal property. In addition, it offers compensation for loss of use (for example, compensation if clients must move out of their homes for a period of time) and public liability protection (if an accident occurs on the premises).

.02 It is safe to say that clients who own homes or live in apartments they leased must have homeowners or tenants insurance. For homeowners, their home is usually one of their largest assets. This is true whether the home is a house, a cooperative, or a condominium. Homeowners insurance is even more critical when there are loans or mortgages against the property. Without homeowners insurance, if a loss occurs, the individual would own property that has declined dramatically in value and still be forced to repay a loan with a remaining balance far more than the property could be sold for. Whether clients own homes or rent apartments, damage to or loss of personal property can be an expensive event. In each of these situations, an uninsured homeowner's loss means that investment dollars would be diverted to replace property or pay substantial liability claims.

The CPA's Role

.03 The CPA's role in evaluating homeowners insurance should be to review insurance policies to make sure they are adequate and appropriate for the client, as well as to verify that the agent has made any recommended changes. It is also important to check that no gap exists between the various casualty coverages. Many clients are underinsured or currently own policies that are not cost efficient. Clients frequently do not understand the difference between replacement cost and market value, and they could be confused about who is covered, what property is covered, and for how much. (See exhibit 3/500-24.)

.04 As a part of the planning process, the CPA should help clients understand who is covered under a homeowners policy and the types of losses covered. It is possible to do this with the assistance of the client's insurance adviser. (See exhibit 3/500-25.)

Key Terminology Used in Homeowners Insurance Policies

.05 Proximate Cause. Proximate cause is an unbroken series of events leading from a cause to an effect. It is the immediate or actual cause of loss under an insurance policy without which the result would not have happened. For example, if you can trace the cause of smoke damage back to a hostile fire (which is a fire that has escaped from its intended confines as opposed to a friendly fire, which is one that burns within its intended confines) through an unbroken chain of events, the hostile fire is the proximate cause of the loss.

.06 Principle of Indemnity. An insured is entitled to payment from an insurance company only if the insured suffered a loss and then only to the extent of the financial loss sustained. The simple reason for this is that the insured is not to profit from insurance, but in the event of a loss, the insured is to be brought back to the same position as before the occurrence. This principle is enforced through insurance contract provisions designed to limit the amount the insured can collect to the amount of the loss. The following four points are an integral part of the principle of indemnity.

1. *Insurable interest.* The interest arising when an insured has a demonstratable economic interest in the property insured that would result in financial loss on damage to or destruction of that property.
2. *Actual cash value.* Unless otherwise stated in the policy, the insured is entitled to recover an amount limited to the actual cash value. Actual cash value is the excess of replacement cost over depreciation. Claims can either be submitted on a claims-made or occurrence basis. (See discussion below.)
3. *Pro-rata share.* Each company jointly insuring a risk with one or more carriers is liable for no more than its fair share of the loss.
4. *Subrogation.* Once a company insuring a risk has paid you for a loss, it acquires your right to sue the party responsible for the loss. (See ¶ 3/5100.25 for more detail.)

.07 Occurrence Basis. Under an occurrence basis, coverage is based on the date when injury or damage occurs and covers claims made at anytime for injuries that occur during the policy period. In short, it pays for anything that happens during the policy period no matter when the claim is made.

.08 Claims-Made Basis. Under a claims-made basis, coverage applies not on the basis at the time at which the injury or damage occurred, but at the time that the claim is filed with the insurer. In short, it pays for anything that happened during the period that is claimed during that period.

Homeowners Policy Design

.09 Generally, homeowners policies are divided into two sections. Section I provides coverage for property and Section II provides coverage for liability and medical payment. The liability and medical payment coverage is usually identical under all policies; however, there can be a number of differences in the Section I coverage. The following describes the most common provisions of homeowners policies; there can be variations, usually minor in coverage.

.10 Section I. Within Section I of the standard homeowners policy (property insurance coverage), there are four coverages designated A, B, C, and D. (See exhibit 3/500-26.)

- *Coverage A: Dwelling.* Coverage A provides protection of the insured premises, which includes the house and grounds, dwelling unit if it is a condominium, cooperative, or mobile home. The amount of Coverage A is designated by the prospective insured. The best choice for the amount of this coverage would be 100 percent of the replacement cost of the property to be insured. The amount of coverage chosen for the dwelling under Coverage A then determines the coverage for B, C, and D, which is a percentage of Coverage A.
- *Coverage B: Other Structures.* Coverage B covers buildings and other structures that are unattached and on the property, such as a detached garage, a tool shed, a patio, and the like. This amount is automatically 10 percent of the amount selected in Coverage A. If there is a need to increase this standard amount of coverage, a rider can be obtained to provide for the increase.
- *Coverage C: Contents or Personal Property.* Coverage C covers personal property and all contents of the insured buildings. The amount of coverage is a stated percentage, often 50 percent of the amount provided for the dwelling (Coverage A). However, policies usually contain specific internal limits that limit payment for specific categories of items, such as silver, $2,500; jewelry, watches, and furs, $1,000; and so on. This means that even if a client owns six pieces of silver at $1,000 each, the total amount recovered may only be $2,500. Payments are usually actual cash value (replacement less depreciation), but riders are available for payment based on replacement cost. Clearly, if the client can afford the higher premium, replacement cost coverage is important to have, as well as riders that cover individual pieces of personal property based on actual appraised values.
- *Coverage D: Loss of Use.* Coverage D, under the standard homeowners policy, provides indemnification of expenses resulting from loss of use of property. It

is payment of outside additional living expenses. This coverage recognizes that if major damage or destruction of the dwelling occurs, the client could incur additional costs for food, rent, and utilities. Under certain types of contracts, coverage may be 20 percent of Coverage A. The expenses covered cannot be at a higher living standard than the client's living standard before the loss of use occurred. Other coverages included in the property section are loss of rent (if the damage forces a renter to leave the house), credit card coverage up to $1,000 (if cards are stolen and used), and other minor expenses.

.11 **Section II.** Section II of the homeowners policies is actually a package of liability coverages.

- *Coverage E: Personal Liability.* Coverage E provides personal liability protection against bodily injury or property damage at home and away from home as well. The amount of liability protection is usually $100,000 per occurrence. Under the insuring agreement for Coverage E, the insurance company promises to pay, up to the limit of liabilities on the policy, all the payments that become the insured's legal obligation because of bodily injury or property damage falling within the scope of the coverage. This general liability coverage is designed to protect the insured in a comprehensive fashion in that it insures against all types of liability hazards except those specifically excluded. Typical exclusions under this section are business-related liabilities and automobile-related liabilities. Thus, it is designed to provide protection against the nonbusiness, nonautomobile exposures of the individual or family unit. Protection exists for the legal liability arising from the premises themselves and from the personal activity of the insured or the family members of the insured, both on and away from the premises. Policies also include employers' liability coverage for an injury to domestic employees when domestic workers are not subject to workers' compensation laws.
- *Coverage F: Medical Payments to Others.* Coverage F is medical payment to others. Third-party medical expenses are covered for up to three years for individuals injured as a result of actions by a family member. This amount is usually $1,000 per person, which can be increased by specific rider coverage. The insuring agreement under the medical payments provision requires that the insurer pay all reasonable medical expenses (including funeral expenses) incurred by persons who are injured while on the premises with the permission of any insured or by persons who are injured away from the premises if the injury results from an activity of the insured or a member of the insured's family. This coverage does not apply to the insured or the insured's family members, themselves, or anyone else residing on the premises of the insured except for domestic workers.

Types of Homeowners Policies

.12 There are six standard homeowners forms, designated HO-1, HO-2, HO-3, HO-4, HO-6, and HO-8. These forms are for the use of owner-occupied dwellings, except for HO-4, which is used exclusively for tenants. Generally, the insured premises cannot contain more than two families and have more than two owners per family. HO-1, HO-2, and HO-3 are for the typical owner-occupied home; HO-6 is for condominium owners, and HO-8 is a special form of contract that is used for owners of homes whose market values differ substantially from their replacement costs. The rule of thumb here is that for houses (other than condominiums or cooperatives), the higher the number (from HO-1 through HO-3), the more comprehensive the policy. Exhibit 3/500-27 illustrates the differences among the policies.

.13 HO-1. The HO-1 policy is called the *basic named peril* and, as the name implies, it only covers losses specifically listed in the policies. The following perils are covered under an HO-1 policy:

- Fire
- Lightning
- Windstorm
- Hail
- Aircraft
- Riot/civil commotion
- Vehicles
- Explosion
- Smoke
- Vandalism
- Malicious mischief
- Glass

.14 HO-2. The HO-2 policy is called the *broad named peril*, and it provides broader coverage for the following HO-1 perils: smoke, vehicle damage, and glass breakage. In addition to the perils listed in HO-1, the following perils are covered under an HO-2 policy:

- Burglary
- Falling objects
- Weight of ice
- Snow/sleet
- Collapse
- Explosion of steam/hot water, air conditioner, automatic sprinkler system
- Freezing
- Accidental discharge or overflow of water/steam
- Damage from artificially generated electrical current

Because the policyholder has the burden of proving that the cause of the loss fits one of the specific perils covered, rather than falling into a gap in coverage, there are broad gaps in coverage.

.15 HO-3. The HO-3 policy is called the *open peril* (all risk) coverage. The HO-3 policy has specific exclusions, such as earthquakes and floods, instead of named, specific causes of loss. The burden of proof is shifted to the insurance company to show that the cause of damage was one of the policy's few exclusions. An HO-3 policy provides open peril coverage for Coverages A, B, and D. Under an HO-3 policy, protection for personal property is provided by the same named peril Coverage C as in an HO-2. The advantage of an HO-3 is that the client can purchase additional coverage for those exclusions, such as earthquakes, floods, and volcanic eruptions. These coverages are available by endorsement to homeowners policies for additional premiums and are applicable only to Coverages A, B, and C. A special deductible applies separately to each coverage, with a $250 minimum deductible for any one loss. Other exclusions include the following:

- Perils of war
- Nuclear accidents
- Freezing of plumbing or heating systems
- Earth movements
- Floods
- Air-conditioning systems
- Wear and tear
- Rust
- Power interruption
- Normal deterioration
- Damage by mice/vermin
- Mechanical breakdown
- Settling or cracking of pavements and foundations

.16 HO-4. The choice for apartment dwellers, the HO-4 policy provides basic contents and personal liability coverage, without the unnecessary expense of coverage of any structures. Coverage is almost identical to HO-2 except for the treatment of glass coverage. Under an HO-4 policy, glass breakage is a named peril coverage, while under an HO-2 policy, glass breakage is all-risk. The personal property coverage of an HO-4 policy is extended to cover building improvements, additions, and alterations. No coverage is provided for damages to the original walls, floors, ceilings, and fixtures of the buildings.

.17 HO-6. An HO-6 policy is designed for owners of condominiums or cooperatives. In a condominium, the owner owns the interior walls, ceilings, and floors, and that which covers the structure. HO-6 policy coverage is similar to HO-4 policy coverage, except that an HO-6 policy provides replacement value coverage for additions, alterations, fixtures, improvements, and installations within the unit, and endorsements are added to an HO-6 policy to reflect the specific nature of the form of ownership. For instance, some policies include all-risk coverage, insured's share of the loss outside the condominium unit, rental to others, other structures (sheds), and loss-assessment coverage. For cooperative owners, HO-6 policy endorsements cover the owner's personal belongings, as well as important liability insurance that is not in an HO-4 policy.

.18 HO-8. The HO-8 policy is usually used for older homes whose replacement costs are much higher than their market values, because of extraordinary workmanship, and the like. This coverage is a modification to HO-1. With an HO-8 policy, the owner can only buy property coverages for the actual cash value of the house, not for the replacement cost, modified on-premises theft coverage of $1,000, and trees and shrubbery of $250.

Clauses in Homeowners Policies

.19 Replacement Cost. An understanding of the definition of replacement cost is critical when evaluating homeowners insurance policies. Replacement cost means that the insurance company will pay the cost of replacing the house with the same standard of materials and workmanship that were used to construct it. Unless otherwise specified in the policy, replacement cost applies only to buildings. Coverage A (dwelling) must be at least 80 percent of the replacement cost to get the full benefit of the policy. Otherwise, the client could only receive benefits up to the actual cash value, which is replacement cost less physical depreciation as calculated by the insurance company.

.20 Some companies offer *guaranteed replacement cost*, which means that the insurance company may replace the home no matter how much it costs to do so. Clearly, this is a benefit that all clients should consider having, if possible.

.21 Coinsurance Clause. The coinsurance clause limits the liability of the insurer to the portion of the loss that the insurance amount bears to a given percentage of the value of the property at the time of loss. In short, if a property is insured for 100 percent of replacement cost, the insured need not worry about the coinsurance provision and can expect a 100 percent reimbursement in the event of a loss less the deductible, if any. Because it is difficult to know what 100 percent replacement cost is at a particular time, the companies are more liberal in applying the coinsurance provision and may state that as long as the amount of insurance carried equals 80 percent of replacement value (referred to as the 80 percent coinsurance clause), partial losses are reimbursed at 100 percent, up to the policy limit. (See exhibit 3/500-28.)

.22 In most cases, a client will want to know how much insurance to carry. The recommended amount would be the actual replacement cost value of the property in question. To receive 100 percent reimbursement for a partial loss the amount of insurance required is calculated by multiplying the replacement cost by the policy's required coinsurance provision, typically 80 percent.

.23 If the client carries less than 100 percent reimbursement on any partial loss, the loss payment can be predicted by the following formula:

$$\frac{\text{Amount of Insurance Carried}}{\text{Amount of Insurance Required}} \times \text{Loss} - \text{Deductible} = \text{Amount of the Recovery}$$

.24 For example, a CPA's client owns a home on a one-acre lot that has a replacement value of $100,000. The contract has an 80 percent coinsurance clause. Therefore, the amount of insurance required to be 100 percent reimbursed on any *partial* loss would be $80,000. In reviewing the homeowners insurance policy, the CPA discovers that only $40,000 of insurance is actually carried on this particular property. If the client had a loss of $20,000, and the policy has a $250 deductible, the client would recover $9,750.

$$\frac{\$40{,}000 \text{ insurance carried}}{\$80{,}000 \text{ required}} \times \$20{,}000 - \$250 = \$9{,}750 \text{ recovery}$$

.25 **Subrogation.** The subrogation clause in a homeowners policy requires the insured to assign his or her right of recovery against a third party to the insurer to the extent payment has been made under the contract. Thus, when an insured experiences a loss with a properly insured piece of real estate, it is the obligation of the insurer to indemnify the individual for that loss. Once the insurer has indemnified the insured for the loss, the subrogation clause allows that insurer to make a claim against an identifiable third party, who may have caused the loss, in order to recover what it paid its insured.

Flood Insurance

.26 Since 1968, a federal program provides subsidized flood insurance to homeowners and small businesses in some 17,000 designated areas. The federal program was necessary because people on mountain tops would not buy flood insurance, whereas people living in river bottoms do. People living in split-levels and those with basements that have been substantially improved need to be aware that this insurance is not comprehensive. It only covers specified items such as the furnace, water heater, pump and floors. When considering flood insurance it is necessary to review the exclusions carefully.

Miscellaneous Problems

.27 When more than one policy covers a client's property, claim payments are made on what is called the appointment clause. It is against public policy to allow an individual to buy casualty insurance policies on one property and to make a profit in the event of the destruction of that property. If this were not the rule, the purchase of multiple policies could encourage arson or other fraud. As a result, when more than one policy covers a property, each policy participates in the payment of the claim on the basis of the percentage that it represents to all insurance carried on that property.

.28 For example, a CPA's client insures the family home, which has a fair market value of $100,000, with two insurance companies. Each company writes $100,000 of coverage on the home. While covered, the home is 100 percent destroyed in a fire. The result of the client's claims under the two policies is that each company pays $50,000 ($100,000 ÷ $200,000 coverage = 50% allocable to each). Each company pays in the ratio of the amount of the coverage it underwrites to the total insurance on the property. Thus, on these facts, if the coverage on the policies were $75,000 and 100,000, the companies would pay $42,857 ($75,000/175,000 × $100,000) and $57,143 ($100,00/$175,000 × $100,000) respectively.

.29 Business Use of the Home. Many clients operate part- or full-time businesses from their homes. The insured should be aware that business pursuits are *excluded* for liability purposes under general homeowners insurance policies. An endorsement called the *Incidental Office Occupancy Endorsement* is required to provide the appropriate additional coverage. Without an endorsement, business property at home is generally covered up to $2,500.

.30 Notice of Loss. When a loss has occurred, the insured should call the appropriate authorities (police, fire department, power company) immediately and inform the insurance company of the loss, preferably in writing.

.31 Additional Damage. The client has an obligation *to protect the property from additional damage*. For example, if electricity has been cut to a house damaged in a fire, and before heat is restored the pipes freeze and burst, the additional damage would not be covered because the client did not protect against additional damage by, for instance, making sure the pipes were drained and the water was cut off.

.32 Personal Property Limitations. Under the standard homeowner policy forms, there are specific limitations applicable to listed types of property. Exhibit 3/500-29 can help the CPA review a client's inventory of assets and liabilities, and recommend riders to increase coverages for property exceeding the limitations shown.

Each item in the above can be increased by the use of specific personal property riders.

.33 Additional Coverages. In addition to the specific rider coverages mentioned above, coverage is also provided under homeowners policies for tree removal (5 percent of Coverage A) and reasonable repairs and the cost of taking reasonable steps to protect and preserve the property after a loss (5 percent of Coverage A). A fire department service charge of up to $500 is covered, as is property removal. Generally, the policies also pay up to $1,000 for losses resulting from the unauthorized use of a credit card issued or registered to any insured. In addition, under the HO-6 (homeowners policy for condominium/cooperative unit owners), a loss assessment is extended to cover losses sustained by the association and assessed against the individual unit owners up to the extent of $1,000 for Section I losses.

.34 Who Is Insured Under the Policy. The term *insured* under a client's policy refers to the following residents of that client's household:

- The client's relatives
- Any other person under age twenty-one who is in the care of the client or the client's relatives

- Any person or organization legally responsible for the client's animals or watercraft
- For any vehicle to which a client's policy applies, any person whom that client employs or any other person using a covered vehicle on that client's premises with the client's consent. This coverage is for unlicensed motor vehicles and other vehicles that are used for maintenance of the premises or recreational vehicles

.35 **Insured Premises.** As long as the insured has disclosed the ownership and location of all owned premises and has paid the appropriate premium, coverage is afforded for liability arising from the premises. An insured location obviously is the residence, but other locations are automatically insured as well, such as vacant land owned or rented to any insured, individual or family cemetery lots or burial vaults, and any part of a premises occasionally rented to an insured for other than business purposes.

.36 The CPA should consider looking on the declaration page of real estate insurance policies for a listing of the residence and all other residential premises that the client may be using. If the insured owned a property that was not declared to be an insured property on the policy at the inception of the policy, that premises is not an insured location.

Action Tips

.37 The CPA should consider the following for better homeowners insurance coverage.*

- Do not rely on policy names such as *comprehensive* and *all risk*. Many of these policies are anything but comprehensive. Look for the policy type (HO-3, for example) and know the policy's terms before buying.
- Make an inventory of all personal property and keep it in a safe place away from the home, along with sales receipts if possible. Videotaped inventories are especially useful.
- Install smoke alarms. There may even be a premium discount for doing so.
- Consider keeping fire extinguishers on the premises. There may be a premium discount for doing so.
- Make sure the client gets the nonsmokers' premium discount if the client qualifies.
- Have valuable personal property appraised and obtain additional coverage (via an endorsement) for it.
- Before a trip, check to make sure that whatever items the client takes are covered under the homeowners policy.
- If the client lives in an area prone to earthquakes or floods, buy additional insurance to cover these risks.
- Obtain replacement cost coverage for your home and personal property, if you can.
- If the client owns a condominium, make sure the individual policy covers the items that the condominium master policy does not. For example, which policy may pay to replace the front door?
- If the client owns a boat, check what special insurance coverage is needed.

* Adapted from: Virginia Applegarth *How to Protect Your Family with Insurance* (Boston: Houghton Mifflin Company, 1990) 76. Used with permission.

3/5105 AUTOMOBILE INSURANCE

Introduction

.01 Automobile insurance is actually a package of coverages for personal injury and property damage. It has two major components. First, liability (comprehensive) coverages provide protection against personal injury to others (including pain and suffering), protection of passengers against uninsured and underinsured motorists, lost wages, and medical expenses. Second, property damage (collision) insurance also provides protection against property damaged by the insured.

.02 Most states require evidence of insurance for an individual to register an automobile. There are minimums, or statutory requirements, that are mandated by state law, but these are almost always inadequate. In a few states, if a driver can prove the financial ability to pay claims, purchasing automobile insurance can be avoided. With frequent claims of hundreds of thousands of dollars and more, however, this is never advisable.

.03 This discussion focuses on passenger cars used for personal purposes.

The CPA's Role

.04 The CPA's role in evaluating automobile insurance should be to provide a general review of the existing coverage to make sure the client is adequately covered and that the automobile coverage is coordinated with other insurance, such as personal liability insurance. (See exhibit 3/500-30.) Clients particularly need assistance in the area of automobile insurance because they are vulnerable to claims and often lack knowledge about their coverage.

The Personal Auto Policy

.05 By far, the most widely used auto policy is the Personal Auto Policy (PAP). This policy provides protection for legal liability, injury to the insured or members of the insured's family, and damage to or loss of the automobile itself. The policy provisions are flexible in how they provide protection in various situations. The carriers writing PAP coverage recognize that many people operate motor vehicles that they do not own. This means that the policy must provide protection to the insured both when operating nonowned vehicles and when someone else is operating the insured's vehicle.

.06 To be eligible for PAP coverage, the vehicle must be owned by an individual or by a husband and wife who are residents of the same household. If a vehicle is owned by residents of the same household who are not husband and wife, a special endorsement is necessary for PAP coverage. Other vehicles are not eligible for PAP coverage.

.07 Also, for a vehicle to have PAP coverage, it must be a private passenger automobile. That is, the vehicle must be a four-wheeled motor vehicle other than a truck, owned or leased under a contract for a continuous period of at least six months. The vehicle cannot be used as a public or livery conveyance, and it cannot be rented to others.

.08 If a client needs coverage on a vehicle, such as a motorcycle, motor home, golf cart, or other type of recreational vehicle, PAP coverage is available by endorsement.

.09 PAP policies have six main parts. Exhibit 3/500-31 lists recommended amounts of coverage.

.10 Part A — Liability Coverage. Automobile liability coverage protects insurers against liabilities they may incur because they own, maintain, or use an automobile. Liability coverage includes bodily injury and property damage. The bodily injury liability portion covers anyone other than the driver of the car for injuries caused by the driver. The coverage includes actual expenses, such as medical expenses and funeral expenses, as well as compensation for pain and suffering, and lost income.

.11 Property damage liability covers damage caused to any kind of property, not just automobiles. It does not pay for damage to the insured's automobile, which is covered under collision or comprehensive coverage. On some policies, the coverages are listed as, for example, "10/20". This means that the policy would cover $10,000 per person and $20,000 per accident. In some states, individuals can choose split limits, that is, there are separate amounts *per individual* and *per accident*; other states have one limit for all, that is, one individual could collect up to the full liability amount provided. Recommended minimum amounts of liability coverage are $250,000 per individual and $500,000 per accident.

.12 Part B — Medical Payment Coverage. Medical payment coverage protects the insured, resident members of the family and others using the car with the owner's permission against medical costs incurred when they are injured while in, getting into, or getting out of any automobile regardless of ownership and if they are injured by motor vehicle as a pedestrian or on a bicycle. Medical payment coverage usually has a basic limit of $1,000, but amounts up to $10,000 or more can be purchased. There is no aggregate limit. Medical payment coverage pays regardless of the injured party's medical insurance, although the insurer can recover any insurance payments made for the insured as long as the amounts are reasonable. It also covers funeral expenses. All of these expenses must occur within the first three years following an accident. It does not cover nonfamily members if they are injured as pedestrians.

.13 Part C — Uninsured/Underinsured Motorist Coverage. Uninsured motorist coverage insures against losses sustained by the insured, family, and passengers in the car, on foot, or on a bicycle when injured through the negligence of an uninsured, underinsured, or unidentified motorist. It pays the insured what would have been collected had the uninsured motorist had actual coverage. This is critical coverage for all clients because so many drivers are uninsured or carry inadequate insurance.

.14 For example, if a client is in an accident caused by an uninsured individual and has uninsured motorist coverage of $10,000, regardless of the extent of the client's injuries, the only guaranteed recourse is through the client's own insurance company, which may pay the client up to the $10,000 limit. Of course, the client can sue the uninsured individual for damages, but an individual who does not have insurance coverage is also not likely to have assets to satisfy judgment.

.15 The case may be compared with that of an accident caused by an underinsured individual. The client's insurance company would pay up to $10,000. The client would then obtain another $10,000 or so from the other driver's insurance company (or whatever that driver's limits are), and then the only recourse would be to sue the driver.

.16 As in Part A, the liability section, the recommended amounts of uninsured/underinsured motorist coverage are $250,000 per individual and $500,000 per accident.

.17 Part D — Physical Damage Coverage. Physical damage coverage — collision and comprehensive insurance — pays the actual cash value of damage, loss or destruction to an automobile. Collision coverage provides protection when the insured's automobile collides with an object (virtually any object except an animal) or is overturned for any reason. The problem with collision insurance is that it only covers up to the actual cash value (or the depreciated value) of the car. Thus, if a client's car sustains substantial damage, the insurance company has the option of either repairing the vehicle or paying the actual cash value of the car (total loss), forcing the client to replace the car.

.18 Comprehensive coverage provides all-risk property coverage for everything that is not covered by collision (including collision with animals). Both comprehensive and collision insurance have deductibles. In determining the amount of the deductible, a good rule of thumb is to take the highest comfortable deductible. Generally, it is not economical to have collision and comprehensive coverage for older cars (five years or older), or when the premium for each of those coverages equals 10 percent or more of the actual cash value of the car.

.19 Part E — Duties After an Accident or a Loss. An automobile accident is normally a traumatic experience, and most people do not think at their best when involved in one. Therefore, the CPA should instruct clients about what to do in the event of an accident to benefit from their coverages, as follows:

- If required by law, the client should immediately report the accident to the police.
- The client should cooperate with the client's insurer in the investigation, settlement, or defense of any claims. Accident report forms on which to report the necessary information about the accident, such as other driver, other insurance carrier, type of the other car, diagram of accident, description of damage, and witnesses are usually provided by the insurer.
- The client should be prompt in sending the insurer copies of any notices and legal papers received in connection with the claim.

- The client should submit to physical examinations by physicians selected by the client's insurer as often as the insurer reasonably requires. The insurer should pay the cost of the examinations.
- The client should authorize the client's insurer to obtain medical reports and other pertinent records relating to the claim.
- The client should submit a proof of loss when required by the client's insurer.

.20 Because conflicts with the client's insurer are possible, or the client could seek damages directly from the party causing an accident, the client should be advised to confer with an attorney.

.21 Any time the police are involved, it is essential to get a copy of any police reports. This is particularly important when the client seeks to invoke uninsured motorist coverage. In the event of a hit-and-run accident, prompt notification of the police is essential.

.22 In the case of physical damage to a vehicle, the client is obligated to take reasonable steps after the loss to have the car inspected to assess the damage and to protect the automobile and equipment from further loss. The insurer may pay expenses incurred in providing this protection. If the police impound a client's vehicle following an accident, they must allow the insurance company to inspect and appraise the damaged property while it is in their custody.

.23 Part F — Personal Auto Policy (PAP) Provisions. Like the homeowners policy, the personal auto policy (PAP) begins with a declaration page that includes most of the basic information about the insurer, the insured, the policy period, the automobiles, the premium, and the limits of liability for each of the coverages. Vehicle information provides the insurer with the data used to base the underwriting and costs of the policy. This information describes the vehicle, its value, its use, and any lender with a secured interest in the vehicle. The coverage portions listed on the declaration page are identified as A through D. Part A identifies the liability coverage, Part B the medical payments coverage, Part C the uninsured/underinsured motorist coverage, and Part D damage to the auto coverage. The PAP can also include Part E, which relates to the duties of the insured after an accident or loss.

.24 Part F, which contains the general provisions of the contract, covers the assignment of the policy, the cancellation provisions, and the subrogation clause. It explains what happens when multiple auto policies apply to the same accident, and enumerates the other provisions necessary for the proper administration of the contract. It also covers bankruptcy changes, fraud, legal action against the company, insurer's right to recover payment, policy period and territory, termination, and transfer of interest.

No-Fault Insurance

.25 Many clients assume that their automobile insurance coverage is adequate because they live in a no-fault state. No-fault laws vary from state to state, but generally no-fault means that the client's insurance company pays first, regardless of who is at fault. Only when insurance coverage limitations are reached can the insured apply for benefits from the other party's insurance company. No-fault laws were enacted to expedite claims payment and to free up a court system plagued by years of delay. However, pure no-fault insurance provides very little compensation for pain and suffering resulting from an accident. Therefore, substantial claims can still arise when an injured individual sues the driver who was at fault for the injuries. For this reason, the CPA should recommend that the client provide the maximum automobile insurance that can reasonably be afforded.

Other Options

.26 Towing and rental are two other available options that are often recommended. Towing, up to the limits of $15 or $20 per incident, can be provided if the car has been in an accident or has become disabled for a mechanical reason. However, with rental coverage, rental expenses may be covered only if the vehicle was stolen or in an accident. With both of these options, the CPA should check to see if the client has duplicate coverage through an automobile package plan or motor club, such as AAA (Automobile Association of America) or a gas company's credit card.

Premiums

.27 PAP premiums vary widely and depend on a variety of factors. These include the drivers' ages (teenagers pay more than adults), sex (men pay more than women), marital status (married individuals pay less than single individuals), past driving record (previous tickets and accidents generally result in increased premiums), year and make of auto (a good rule of thumb is the flashier or more powerful the car, the more the insurance may cost), mileage (the more one drives, the more expensive the insurance is), formal driver's education (taking a course could reduce premiums), and location (premiums vary from state to state, and cars garaged in urban areas cost more to insure than those kept in rural areas).

Who Is Covered

.28 Basically, anyone listed as a driver on the policy is covered when driving any passenger car (even one that is not owned such as a borrowed or rented car), injured by any vehicle while walking, or while riding a bicycle. Whether passengers are covered in an insured car or not varies by state, but a good assumption is that they are. Finally, anyone driving the car with the owner's permission is covered. Unless there is a specific endorsement to the automobile policy, anyone who uses a car covered by a PAP for business purposes is usually not covered.

Filing for Claims

.29 Although reporting an accident may cause a client's rates to increase if there is any question of the client's fault, it is better to do so than to risk a suit being brought later against the client. If a client becomes dissatisfied with the insurance company's performance, the client can request arbitration. A final step is to take legal action against the insurance company. It is strongly suggested that the client be advised to seek legal counsel following an accident.

Other Vehicles

.30 With the increase in the popularity of motorcycles, mopeds, all-terrain vehicles, snowmobiles, and other miscellaneous vehicles, it is essential that the CPA advise clients to ask for specific coverage for those vehicles. Frequently, it is possible to get an endorsement on an auto policy: a *miscellaneous vehicle endorsement.* Coverage under the endorsement is not provided for vehicles the client does not own.

.31 Business vehicles are unique; they need their own special insurance. The CPA should consider seeking the assistance of a property casualty professional to obtain adequate and quality coverage for a client.

Policy Period and Territory

.32 The policy applies only to accidents and losses that occur during the policy period (as shown on the declaration page) and within the policy territory. The policy territory generally is the United States, its territories or possessions, and Canada. There is no coverage under a policy for Mexico.

Action Tips

.33 For finding better coverage the CPA should consider the following:*

- Does the state regulate insurance premiums? If not, the client should shop around for both price and service. If premium prices are fixed, the client should shop for service alone.
- If the client has taken the highest deductibles.
- If the client has reviewed the comprehensive and collision coverage in light of the extra premium.
- If the client has more than one car in the family, consider having them all insured with the same company to get a multicar discount. To qualify, the cars must be owned by a family member living with the client.
- The state's no-fault laws, if applicable.
- When reviewing a client's policy, check the amounts on the policy against what the client asked for. With such a variety of possible coverages, it is easy for the agent or company to make a mistake.
- Remind clients to inform their companies of any changes that could reduce or increase their premiums. Otherwise, clients may be paying too much or may be inadequately covered.

* Adapted from: Virginia Applegarth *How to Protect Your Family with Insurance* (Boston: Houghton Mifflin Company, 1990) 62. Used with permission.

- Remind clients to determine if their cars' sound systems, radar detectors, or car phones are covered under their auto or homeowners policies. If not, advise clients to buy additional protection for these items.
- If a client changes insurance companies in the middle of the policy year, a penalty is usually charged, called a short rate. If the premiums saved from changing are more than the penalty, the client should make the change. If not, the client should wait until the policy anniversary.

3/5110 PERSONAL LIABILITY INSURANCE

Introduction

.01 Personal liability insurance protects against damages resulting from negligence of the insured. The compensation could be for one or all of the following:

- Physical injury (a mailman slips on the client's walkway)
- Monetary damage (the mailman loses income due to the slip on the walk)
- Slander (the client falsely said that the mailman was intoxicated and that is why he slipped on the walk)
- Emotional stress (the mailman no longer has peace of mind because he slipped on the walk and was said to be intoxicated)
- Property damage (the mailman ripped his uniform when he fell)

Considering 1991 costs and the increasing size of awards to complaining parties, a safe assumption is that virtually all clients need a minimum of $1 million in total personal liability coverage, including automobile, homeowners, and umbrella policies. Many clients need more than this amount, and it is not uncommon for clients to seek coverage of $5 million or more. (See exhibits 3/500-32 and 3/500-33 for Model Letters designed to elicit this information.)

The CPA's Role

.02 The CPA's role in evaluating personal liability insurance should be to see to it that the client's assets are adequately protected in the event of a lawsuit. It is important that the CPA ascertain whether the client's homeowners and automobile policies provide adequate coverage; that the personal liability policy covers such things as slander, libel, and invasion of privacy; and that appropriate liability coverage is obtained for any business undertakings.

The Policy

.03 Basic personal liability insurance is part of a homeowners or automobile policy. Coverage exceeding the limits of a homeowners or automobile policy can be obtained by a separate contract, generally called an *umbrella policy* because it provides an umbrella of coverage for the insured and the insured's family. The umbrella policy picks up where a homeowners or automobile insurance policy leaves off. This is because the maximum amount available on a homeowners policy is usually $300,000, with $500,000 generally available on an automobile policy. Both of these amounts were considered to be inadequate in 1991. A personal umbrella policy has deductibles of $300,000 (for homeowners claims) and $500,000 (for automobile claims), which are paid by the homeowners or automobile policy. When those limits are reached, the umbrella policy provides coverage up to its limits.

.04 In addition, like the homeowners and automobile policies, an umbrella policy pays the legal expenses. The insurance company can settle any claim or suit when it decides that action is appropriate. In addition to the legal expenses, the contract may pay interest on judgments plus certain other related costs.

.05 The insured under an umbrella personal liability policy is the insured (policyholder), relatives who are residents of the insured's own household, and any other person under age 21 who is in the care of a resident of the insured's household.

.06 The policy, generally, will not cover bodily injury or property damage arising out of business pursuits of any insured. However, it is possible to obtain a business pursuits endorsement, in some cases, as long as the insured has disclosed the ownership and location of all owned premises used for business and has paid the appropriate premium coverages afforded for liability arising out of the premises.

.07 When liability is assumed (either voluntarily or through legal action), a personal liability policy will pay all medical expenses including funeral expenses incurred by persons who are injured while on the insured's premises *with the permission of any insured* or are injured away from the premises if the injury results from an activity of an insured or member of the insured's family. In addition to the claims mentioned, the policy may also pay for first aid expenses incurred by the insured related to any amount, usually up to $500 and for damage to the property of others for which there is no legal obligation on the part of the insured but that the insured might feel under a moral obligation to pay.

.08 If a condominium association experiences a loss, and it assesses its membership, coverage of up to $1,000 is provided by the personal liability coverage of a homeowners policy to pay the assessment. This type of coverage may be increased by endorsement to the policy or through an umbrella policy.

.09 In addition to accidents relating to homeowners and automobile claims, the umbrella policy covers some liabilities that homeowners policies generally do not. These include slander (spoken defamation of character), libel (written defamation of character), invasion of privacy, plagiarism, and violations of copyright. Therefore, it is very important to find out if a client's homeowners personal liability policy covers these items.

Business Liability Insurance Policies

.10 There are more than twenty different business liability policies that can be developed by adding coverage to the basic, general liability insurance contract. The best known are the Owners, Landlords, and Tenants policy (OLT); the Manufacturers and Contractors policy (M and C); and the Comprehensive General Liability policy (CGL). These policies follow the general pattern of the personal liability policy in that the insurer promises to pay on behalf of the insured all sums for which the insured becomes obligated to pay as a result of bodily injury or property damage. The insurer agrees to defend any suit brought against the insured for damages, even if the suit is groundless or fraudulent. There are liability policies for:

- Storekeepers
- Those who assume liabilities on a contractual basis
- Officers and directors of homeowners associations
- Officers and directors of other organizations.

There are professional and malpractice insurance liability policies. Not only do physicians and dentists need malpractice insurance, but also accountants, architects, advertisers, attorneys, mental health professionals, insurance brokers and agents, real estate agents, stock brokers, consultants, data processors, and many others who could be held liable for their professional errors or mistakes. The policies for nonmedical professionals are commonly referred to as errors and omissions contracts (see ¶ 3/5115 for further details).

3/5115 ERRORS AND OMISSIONS INSURANCE

Introduction

.01 Errors and omissions insurance, similar to *malpractice insurance*, is a form of liability insurance covering those individuals rendering non-health-care professional services. One sample definition of coverage specifies that the insurance company will "pay on behalf of the insured — whatever amounts — up to the limits of the policy, the insured may become legally required to pay on account of any error, omission, or negligent act on the part of the insured or anyone for whom the insured is legally responsible during the course of rendering professional services." This coverage is only available to a limited number of professionals, such as accountants, architects, engineers, contractors, lawyers, doctors, mental health professionals, realtors, insurance agents, and fiduciaries.

.02 Errors and omissions insurance is appropriate for any client who desires to protect assets from liability judgments stemming from negligence, errors, or omissions that arise from rendering professional services. Failure to procure errors and omissions coverage could threaten not only a professional's accumulated assets but also future earnings for the purpose of satisfying court-imposed liability judgments.

The CPA's Role

.03 The CPA's role in evaluating errors and omissions insurance is to ascertain whether errors and omissions coverage is in force and for what amounts. The CPA should inform the client that setting the maximum coverage is mainly influenced by the level of current judicial settlements and anticipated future levels of similar litigation. Some CPAs mistakenly recommend that the amount of coverage should equal the client's net worth. Plaintiffs in malpractice suits have no interest in limiting their request for damages to the amount of the professional's net worth. Thus, the client should understand that the appropriate amount of coverage is that amount necessary to cover the largest liability judgment that could ever be won against the insured.

The Policy

.04 Benefit Limitations. Errors and omissions coverage generally contains two limits: one for the maximum amount payable for any single claim and a second limit for the aggregate amount payable under the policy for any one year. The aggregate limit is imposed because professionals are subject to multiple claims during any given period of time. The insured chooses the upper limits of the policy in even multiples of the available increments of coverage, such as $1 million increments. Often the insurance company limits the amount of coverage it is willing to write to an amount less than what the client desires to purchase. If this is the case, it is frequently possible to purchase a second policy from another carrier with a deductible amount equal to the limits of the *first* policy.

.05 Deductible. Most errors and omissions policies specify a per-claim deductible that must be satisfied before benefits are payable under the policy. The policies often differ about a deductible applicable to liability for bodily injury claims. Some carriers have no deductible for bodily injury claims, whereas other carriers will often write an endorsement to delete deductible for an additional premium. A client can, in some instances, add a deductible, if it is not already specified, for bodily injury claims and benefit from a reduced premium. Policies differ from one occupation to another. Professions such as accountancy usually do not have coverage for bodily injury claims in the policy itself, whereas that coverage is central to a physician's policy.

.06 Territory. Most errors and omissions policies differ about worldwide coverage. Policies for architects, engineers, and contractors often provide worldwide coverage except for countries, such as the Soviet Union, China, and North Korea. For some professions, the coverage is applicable only for activities within the United States and requires endorsement for activities beyond U.S. boundaries. Clients rendering professional services outside of the base territory specified in the contract should consider seeking an endorsement to extend coverage to the territories in which they operate.

.07 Claims Covered Under the Policy. Professional liability policies have undergone a change in the type of coverage provided. In the past, architects, engineers, contractors, and others creating products or performing procedures that could give rise to liabilities many years later were covered without time limitation under policies that were in force at the time the service was rendered. This is referred to as the *long tail* of liability coverage. As a result of inflation and changing interpretations of liability, the long-tail approach proved unworkable. As a result, newer policies do not provide long-tail coverage.

.08 Coverage is provided on a claims-made basis. This means that it covers liability claims filed during the duration of the coverage or within a specified short period, such as sixty days, after the termination date of the policy. Generally, the policy is not applicable to liability claims filed during the period of coverage that arise from services performed prior to a retroactive reference date, such as a specified number of months or years prior to the inception of the claims-made contract. Frequently, insurance companies will extend the retroactive reference date to earlier periods for additional premiums. Claims-made coverage has allowed the insurance companies to keep premium levels in line with current liability settlements.

.09 **Post-Retirement Coverage.** Because these policies, generally, do not cover claims filed more than sixty days after termination of coverage, professionals are often required to continue purchasing liability coverage beyond their retirement from professional life. Many policies provide post-retirement extensions of coverage at reduced rates for up to six years beyond the expiration date of a policy covering active professional service prior to retirement.

.10 Depending on the profession, retirees can sometimes obtain coverage through their former firms to automatically extend coverage for their preretirement professional services. However, these coverages do not extend to any liabilities created by the actions of the retiree after retirement. That exposure would only be covered by an individual policy acquired by the retiree after retiring from the firm.

.11 **Defense Cost.** Generally, errors and omissions policies stipulate that the insurance company will provide legal defense for the insured. In some contracts these legal defense costs can exceed the policy limit and will still be paid by the carrier. Other contracts provide that legal defense costs are included within the aggregate policy limits. This difference is very important and should be considered when setting the appropriate upper policy limits.

.12 **Consent of the Insured for Settlement.** Some errors and omissions policies provide that the insured must consent to any settlement. This gives the insured the opportunity to object to a compromise settlement and to force a judicial settlement of a liability claim. The insurance policies generally include a provision limiting the liability of the insurance company to that which it would have sustained had it settled on the basis of a rejected but otherwise bona fide settlement offer. Thus, the insured who rejects a compromise settlement could face personal liability without insurance company reimbursement for the excess of any judicial settlement over and above the amount a bona fide settlement could offer. Under some policies, only the named insured can consent to a settlement, whereas under other policies the individual covered under the blanket terms of the policy must give the consent.

.13 **Subrogation.** Errors and omissions policies differ on whether they require subrogation of the rights of the insured to the carrier. Those policies containing subrogation clauses permit the insurance company to pursue the rights of the insured to seek damages against third parties in cases in which the insurance company has paid benefits on behalf of the insured for that claim.

.14 **Libel or Slander.** Errors and omissions policies often differ on how they treat libel or slander. Some of them cover all forms of libel or slander, whereas others differ between criminal and civil libel or slander. Thus, many policies cover civil libel or slander while excluding any coverage for criminal libel or slander. It is important when investigating this coverage to consider the temperament of the client. The CPA should be able to determine when coverage for criminal libel or slander might be indicated.

.15 **Cancellation.** Errors and omissions policies can usually be canceled by the insurance company after advance notice of a specified number of days. In some contracts, that advance notice requirement is only ten days, which is usually an inadequate period of time within which to find replacement coverage. If requested by the insured when cancellation of the contract is being written, some insurance companies may agree to provide a longer advance notice period. The additional time may be needed to locate replacement coverage on the cancellation of existing coverage.

.16 **Exclusions.** Errors and omissions policies contain exclusions for intentionally dishonest or fraudulent acts. Also excluded from coverage are acts as an officer or director of a business enterprise, as a public official, or an employee of a governmental body. The exposure of directors and officers is insurable under another policy specifically designed for that risk. The policies available to some professional groups contain exclusions for any claims for bodily injury, disease, or death of any person or damage to any tangible property. This exclusion is common in policies available to those professionals, such as accountants and lawyers, who are not physically involved with their clients.

.17 **Premiums.** The variation of premiums that carriers charge for errors and omissions coverage is astounding. To some extent, these premiums are a barometer of litigation and settlements associated with the particular profession to be covered. As expected, medical practitioners in high-risk specialties are burdened with some of the highest premium rates for this type of coverage. Annual premiums in excess of $40,000 per year apply to specialties, such as orthopedics and obstetrics gynecology. In fact, the high cost of this coverage has prompted some physicians to give up their specialty and reorient their practice to less risky areas.

.18 A few financial risk takers continue practicing their specialty without the protection of errors and omissions coverage. This is referred to as going *bare*. A professional going bare often announces to clients that there is no liability coverage available for malpractice suits.

Tax Implications of Errors and Omissions Insurance

.19 Premium payments for errors and omissions coverage are tax-deductible business expenses incurred in the course of providing professional services. If benefits are received under an errors and omissions policy they are deemed to be a replacement of lost income taxable as ordinary income. On the other hand, if these benefits are payable as a result of sickness or injury, they are exempt from federal income taxes under either IRC Section 104 or 105.

Action Tips

.20 The CPA should attend to the following features of errors and omissions policies:

- Suggest affiliation with a professional group that makes this protection available to its members as a membership benefit.
- Before advising a client about an underwriting association, the CPA should investigate the health of the association. Underwriting associations are sometimes formed to provide professional liability coverage when none is available from insurance companies and provide some degree of protection, but many of these associations have been terminated by financial failure.
- It is necessary to review the specific policy offered to determine if the policy limitations and exclusions afford adequate protection. Errors and omissions policies are not standardized, significant differences exist from one insurance company to another.

3/5120 BUSINESS INSURANCE

Introduction

.01 Many different types of business insurance are available, and the CPA should consider recommending that the client have a commercial property insurance professional, such as a risk manager or commercial lines broker evaluate the business insurance coverage. Although the potential need for coverage can often be spotted by CPAs through their knowledge of their clients' business activities and properties, the CPA should rely on a competent business insurance expert's review to discover whether:

- An exposure to loss exists,
- Coverage for the loss is appropriate,
- Coverage has been continued on property that has been sold or destroyed,
- Coverage has not been added for new property, or
- Coverage has not been changed for exposures as a result of change in the way business is conducted.

When a business expands either geographically or into new ventures that create new exposure there is generally a need to modify the existing insurance coverage. Insurance is needed for those exposures to loss that are so great that the business could not afford to absorb the potential loss out of funds from operations.

.02 When evaluating business insurance, the form (sole proprietorship, partnership, corporation) of the business should also be considered. The level of coverage a sole proprietor needs could be much greater than that deemed adequate if the same business were carried on in corporate form.

The CPA's Role

.03 The CPA's role when evaluating business insurance should be to consider inquiring about the existence of the most likely needed coverages based on knowledge of the client's business operations, the form of the business, and the client's risk tolerance. It may be appropriate to suggest that a risk manager or insurance broker be engaged to evaluate the client's business insurance needs. In addition, the CPA may be able to spot premium levels that seem out of line and to verify the appropriateness of the coverage when related to the premiums.

.04 The CPA should consider consulting with a Chartered Property Casualty Underwriter when reviewing business insurance with clients.

Business Insurance Packages

.05 For small business enterprises, package policies generally provide needed coverages. These policies usually combine property and liability coverages for the standard risks faced by businesses of the type being insured. However, once the company to be insured has grown beyond the basic profile, there may be a need for more coverage than a package policy provides. One of these policies (Business Owners Policy) is described below.

Business Owners Policy (BOP)

.06 The Business Owners Policy (BOP) provides property and liability coverage in a single contract. The BOP is available for small and medium apartment buildings, offices, service companies, processing firms, and mercantile.

.07 **Eligibility Requirements for a BOP.** Generally, to qualify for a BOP, a business must meet the following maximums (subject to local or carrier variations):

- Mercantile, processing and service firms must occupy fewer than 15,000 square feet.
- Apartment buildings must be less than six stories high and have fewer than sixty dwelling units.
- Office buildings must be less than six stories high and occupy fewer than 100,000 square feet.

.08 Coverage. Coverage can be written in either a Named Peril (Basic BOP) or Open-Peril (Special BOP) format. Coverage under the Basic BOP includes the perils of fire and extended coverage, vandalism, sprinkler leakage, sinkhole collapse, volcanic action, and transportation. Optional coverage of burglary and robbery is also available. Coverage under the Special BOP is on an open-peril basis, subject to the standard open-peril exclusions. Burglary and robbery are automatically included in the Special BOP.

.09 A BOP is divided into two sections: Section 1 (property coverages) and Section 2 (comprehensive business liability coverages). Section 1 includes the following coverages:

- *Coverage A*. Buildings are covered for replacement cost. The definition of building includes garages, storage buildings, fixtures, machinery, equipment, outdoor furniture, trees, shrubs, plants, the insured's personal property used in connection with maintaining and servicing a building, and furnished apartments in the building owned by the insured. This coverage is mandatory if the insured owns the building. An automatic increase in insurance provision is included to keep pace with inflation.
- *Coverage B*. Business personal property customary to the insured's occupancy at the described premises is covered for replacement cost. This coverage also includes off-premises personal property, and personal property acquired at new locations. An automatic increase in insurance provision is included to keep pace with inflation.
- *Coverage C*. Loss of income, an optional coverage, includes continued income for up to twelve months. This coverage provides income during rebuilding, repairing, or replacing the damaged property following the date of loss.
- *Coverage D*. Money and securities coverage is only available under a Special BOP. It covers cash and securities up to $10,000 on the described premises and up to $2,000 off the premises. At the insured's option, securities may be valued at their market value at the time the loss is settled.

.10 Under Section 2, coverage is the same for both Basic and Special BOPs. Other Section 2 provisions are:

- *Coverage E*. Business liability insurance provides coverage of $300,000 for each occurrence, which may be increased to $500,000 or $1,000,000. Fire and legal liability is also offered at $50,000 per occurrence.
- *Coverage F*. Medical payments insurance provides payments to injured persons of $1,000 per person and $10,000 per accident.

.11 Optional Coverages. The following optional coverages may be added to either the Basic or Special BOP policies: employee dishonesty, exterior signs, exterior grade floor, glass, boiler, pressure vessels, and air-conditioning equipment.

Fire Insurance

.12 If fire and extended coverage is available, all premises used by a business should be insured. For leased buildings, it is important that the combination of policies carried by the owner and the tenant provides appropriate protection for the respective interests of each in the buildings. Thus, the CPA should help the client/owner verify that the lease contains a clause to establish the appropriate level of insurance the tenant must provide to assure complete coverage.

Business Interruption Insurance

.13 Business interruption insurance covers losses from interruption of business activities through direct losses of insured property, such as machinery or buildings. The coverage is most appropriate for manufacturing and merchandising operations.

.14 The coverage provides benefits only for losses that show up over the annual accounting cycle when compared to prior years. The loss recovery is based on losses sustained and generally may replace some or all of the fixed expenses and anticipated net profit. The coverage is available with coinsurance ranging from 20 percent to 50 percent borne by the insured. In a few areas of the country, the coverage is available without coinsurance.

.15 For new business ventures, there is a form of coverage that is issued on a valued basis. This means that the level of benefits to be paid during a business interruption is specified in advance.

Accounts Receivable/Valuable Papers Insurance

.16 Accounts receivable/valuable papers coverage provides benefits to reconstruct records after they have been lost. However, before the coverage is written, specific loss prevention procedures, which are designed to reduce the risk of loss by mandating the keeping of duplicate records and secure storage of both sets, must be in place. The coverage does not provide payments for uncollectible accounts.

.17 All businesses should consider implementing the loss prevention procedures whether there is insurance coverage or not. Many experts advise that no coverage is needed if the prescribed safeguards imposed by insurers as a condition of writing the insurance are adhered to at all times.

Crime Insurance

.18 Crime insurance coverage is available as either blanket coverage for nearly all perils or as separate policies for each peril. The perils covered usually include burglary, embezzlement, fidelity bonds, forgery, larceny, misappropriation, robbery, theft, and wrongful abstraction. The minimum policy limits should be high enough to cover the assets at risk, which are usually current assets plus goods on hand or in process.

.19 The insured usually has the option of establishing a period of time from the occurrence to discovery of the loss within which to report the loss to the insurance company. The time period is called the *discovery period* and the options generally range from sixty days to three years. A sixty-day waiting period is too short for embezzlement, forgery, misappropriation, theft, and wrongful abstraction because these crimes often go undetected for months or even years. Thus, the discovery period must be long enough to provide a reasonable chance of detection so that the loss can be covered by the policy.

.20 It is extremely important to keep this coverage in force without even a one-day gap in coverage when switching from one insurer to another. That is because a policy provides benefits on claims filed during the period of coverage even if the loss occurred during a previous policy period, provided there has been coverage continuously in force. A gap in coverage breaks the chain and negates coverage for losses that occurred during prior policy periods.

Workers' Compensation

.21 Workers' compensation provides benefits for work-related bodily injury of employees. The level of benefits is prescribed by law. The coverage is available from insurance companies in all states except Nevada, North Dakota, Ohio, West Virginia, and Wyoming, where the coverage is provided by the state government through an insurance fund. In some states there are competitive state funds for workers' compensation coverage that compete with private insurance companies for this business. The workers' compensation risk can be self-insured in all states except Nevada, North Dakota, Texas, and Wyoming.

.22 Factors that are important in selecting an insurer for workers' compensation are quality of claim service, loss prevention engineering, timeliness of claim payments, completeness of claim investigations, and rehabilitation benefits. The policies may automatically provide coverage to those employees for whom the state law mandates coverage. For an additional optional premium the insurance company will expand coverage to include employees who are exempt under the workers' compensation statute. Another option available is to cover the insured's employees in all states. This assures compliance and coverage for employees sustaining losses anywhere in the United States for the differences in benefit levels among the states. The all-states option is essential when the insured provides transport services nationwide with its own employees.

EXHIBIT 3/500-1

Short Data-Gathering Form
Insurance

Name________________________________ Date____________

Life Insurance	Policy 1	Policy 2	Policy 3
Insured			
Insurance company			
Policy number (or group)			
Policy owner			
Beneficiaries			
Type of policy			
Face amount	$	$	$
Cash-surrender value	$	$	$
Policy loans	$	$	$
Interest rate on loans	%	%	%
Annual premium	$	$	$
Estimated dividend	$	$	$

Disability Insurance

Insured			
Insurance company			
Policy number (or group)			

Disability Insurance (cont.)	Policy 1	Policy 2	Policy 3
Definition of disability: Unable to perform (check one) -- (1) Own occupation			
(2) Occupation for which reasonably suited by training and education			
(3) Any occupation			
(4) Combination of the above			
Waiting period			
Benefit period			
Benefit	$	$	$
Partial disability covered?			
Residual disability covered?			
Annual premium	$	$	$

Medical Insurance	Policy 1	Policy 2
Insured family member(s)		
Insurance company		
Group policy (yes or no)		
Major medical limits: Annual for each individual	$	$

Medical Insurance (cont.)	Policy 1	Policy 2
Lifetime for an individual	$	$
Annual for family	$	$
Lifetime for family	$	$
Deductibles Annual for each individual	$	$
Annual for family	$	$
Co-payment	% until pay $	% until pay $
Annual premium	$	$

Homeowners Insurance	Property 1	Property 2	Property 3
Property address			
Insurance company			
Market value of dwelling	$	$	$
Replacement cost for dwelling	$	$	$
Insurance on dwelling	$	$	$
Personal liability insurance	$	$	$
List personal property insured separately under personal article floaters			
Personal property covered for replacement value?			

Homeowners Insurance (cont.)	Property 1	Property 2	Property 3
Deductible	$	$	$
Annual premium	$	$	$

Automobile	Auto 1	Auto 2	Auto 3
Describe automobile			
Insurance company			
Liability	$	$	$
Property damage	$	$	$
Uninsured motorist coverage?			
Collision?			
Are rental cars covered?			
Deductible	$	$	$
Annual premium	$	$	$

Umbrella Liability

1. Do you have excess liability insurance? ____Yes ____No
2. If so, what is the maximum coverage? $________________
3. Insurance company ________________

Other Property

Do you own property that is not insured? ____Yes ____No

If yes, describe below:

Description	Market Value

EXHIBIT 3/500-2

Long Data-Gathering Form

Insurance

Name______________________ Date__________

Risk Profile (Only list property not itemized on the general data-gathering form.)

	Description	Estimated Market Value
1. Residences and other real estate		
2. Automobiles		
3. Other motor vehicles (including recreational vehicles and trailers)		
4. Boats and airplanes		

	Description	Estimated Market Value
5. Coin collection,	______	______
stamp collection,	______	______
other collect-	______	______
ibles	______	______
6. Jewelry, watches,	______	______
furs (if over	______	______
$1,000)	______	______
7. Silverware, gold-	______	______
ware (if over	______	______
$2,500)	______	______
8. Firearms (if over	______	______
$2,000)	______	______
9. Business property	______	______
at home (if over	______	______
$2,500)	______	______
10. Business property	______	______
used away from	______	______
home (if over	______	______
$250)	______	______

11. Computer hardware and software (if over $2,500) ____________ ____________

12. Does your occupation or your spouse's involve potential liability for malpractice, errors, omissions, or employee liability? ____Yes ____No

Explain ____________________

13. Do you or your spouse serve on the board of directors of any organizations? ____Yes ____No Explain ____________________

14. List any hobbies of family members that are potentially hazardous or could lead to personal liability exposures.

Family Member	Hobby

15. Please explain other possible liability or property exposures that concern you, if any. ____________________

Life Insurance

	Policy 1	Policy 2	Policy 3
Insured			
Insurance company			
Policy number (or group)			
Policy owner			
Issue age			
Type of policy (term, whole life, univ. life, etc.)			
Beneficiaries			
Contingent beneficiaries			
Face amount	$	$	$
Other benefits________			
Cash-surrender value	$	$	$
Policy loans	$	$	$
Interest rate on loans	%	%	%
Annual premium	$	$	$
Estimated dividend	$	$	$
Dividend option			

Disability Insurance

	Policy 1	Policy 2	Policy 3
Insured			
Insurance company			

Disability Insurance (cont.)

	Policy 1	Policy 2	Policy 3
Policy number (or group)			
Definition of disability: Unable to perform (check one) -- (1) own occupation			
(2) occupation for which reasonably suited by training and education			
(3) any occupation			
(4) combination of the above			
Waiting period			
Benefit period			
Monthly benefit	$	$	$
Partial disability covered?			
Residual disability covered?			
Cost-of-living rider?			
Guaranteed renewable?			
Annual premium	$	$	$

Medical Insurance

	Policy 1	Policy 2	Policy 3
Insured family member(s)			
Insurance company			
Group policy (yes or no)			
Hospital expense insurance			
Daily room benefit	$	$	$
Number of days			
Maximum miscellaneous expenses	$	$	$
Surgical expense insurance -- maximum, type of schedule			
Major medical insurance			
Maximum limits:			
Individual -- Annual	$	$	$
Lifetime	$	$	$
Family -- Annual	$	$	$
Lifetime	$	$	$
Deductible Individual	$	$	$
Family	$	$	$
Co-payment	____% of first $	____% of first $	____% of first $
When are second opinions required?			
Annual premium	$	$	$
Dental Deductible	$	$	$
Co-payment	$	$	$
Maximum	$	$	$
Annual premium	$	$	$

Homeowners Insurance

	Property 1	Property 2	Property 3
Property address			
Insurance company			
Policy number			
Homeowners # (see exhibit 3-5B)			
Required co-insurance percent	%	%	%
Cost to replace dwelling	$	$	$
Market value of dwelling	$	$	$
Coverage Dwelling	$	$	$
Personal property	$	$	$
Personal liability	$		
Medical payments to others	$	$	$
Automatic inflation adjustment?			
Personal property covered under personal article floaters (describe): __________	$	$	$
__________	$	$	$
__________	$	$	$
Personal property insured for replacement cost?			
Deductible	$	$	$
Annual premium	$	$	$

Automobile Insurance

	Vehicle 1	Vehicle 2	Vehicle 3
Description of vehicle			
Insurance company			
Policy number			
Named insured			
Other drivers			
Liability limits			
Bodily injury			
Each accident	$	$	$
Each person	$	$	$
Property damage	$	$	$
Medical payments	$	$	$
No-fault benefits	$	$	$
Rental car coverage?			
Uninsured motorist coverage?			
Collision -- deductible	$	$	$
Comprehensive -- deductible	$	$	$
Other ________________			
Annual premium	$	$	$

Umbrella Liability

	Policy 1	Policy 2	Policy 3
Insurance company			
Maximum coverage	$	$	$

Umbrella Liability (cont.)

	Policy 1	Policy 2	Policy 3
Required basic auto liability coverage	$	$	$
Required basic homeowners liability coverage	$	$	$
Other required liability coverages (describe) -- ____________	$	$	$
Annual premium	$	$	$

Other Insurance

	Policy 1	Policy 2	Policy 3
Type of policy			
Covered property or liability			
Insurance company			
Policy number			
Limits Property	$	$	$
Liability	$	$	$
Annual premium	$	$	$

EXHIBIT 3/500-3

Long Data-Gathering Form

Insurance

Name Mark and Judy Sample (2 children, ages 2 and 5) Date 1/2/19X1

Risk Profile (Only list property not itemized on the general data-gathering form.)

	Description	Estimated Market Value
1. Residences and	Residence	200,000
other real estate	Vacation condominium	125,000
2. Automobiles	19X0 Toyota	12,000
	19X0 Chevrolet	6,500
3. Other motor		
vehicles		
(including recre-		
ational vehicles		
and trailers)		
4. Boats and air-	Sailboat	25,000
planes		

	Description	Estimated Market Value
5. Coin collection, stamp collection, other collectibles	Doll collection	3,500
6. Jewelry, watches, furs (if over $1,000)		
7. Silverware, goldware (if over $2,500)		
8. Firearms (if over $2,000)		
9. Business property at home (if over $2,500)		
10. Business property used away from home (if over $250)		

	Description	Estimated Market Value
11. Computer hardware	______	______
and software (if	______	______
over $2,500)	______	______

12. Does your occupation or your spouse's involve potential liability for malpractice, errors, omissions, or employee liability? ____Yes ____No

Explain ______________________________

____

____

13. Do you or your spouse serve on the board of directors of any organizations? _x_ Yes ____No Explain Mark is on employer's board of directors.

____

14. List any hobbies of family members that are potentially hazardous or can lead to personal liability exposures.

Family Member	Hobby
Mark	Rodeo rider

15. Please explain other possible liability or property exposures that concern you, if any. Concerned about college education expenses for children ages 5 and 2 in the event of my premature death.

____

____

Life Insurance

	Policy 1	Policy 2	Policy 3
Insured	Mark	Mark	Judy
Insurance company	XYZ Life	Employer Life	XYZ Life
Policy number (or group)	12345678	group	87654321
Policy owner	Mark	Employer	Mark
Issue age	--	--	10/1/19X0
Type of policy (term, whole life, univ. life, etc.)	Annual renewable term	Group term	Whole life
Beneficiaries	Judy	Judy	Mark
Contingent beneficiaries	children	children	children
Face amount	$100,000	$ 50,000	$ 50,000
Other benefits ________	--	--	--
Cash-surrender value	$--	$--	$ 1,200
Policy loans	$--	$--	$--
Interest rate on loans	-- %	-- %	-- %
Annual premium	$ 354	$ Employer	$ 370
Estimated dividend	$--	$--	$--
Dividend option	--	--	--

Disability Insurance

	Policy 1	Policy 2	Policy 3
Insured	Mark		
Insurance company	ABCD		

Disability Insurance (cont.)

	Policy 1	Policy 2	Policy 3
Policy number (or group)	579321		
Definition of disability: Unable to perform (check one) -- (1) Own occupation	60 days		
(2) Occupation for which reasonably suited by training and education			
(3) Any occupation	after 60 days		
Waiting period	90 days		
Benefit period	to age 65		
Monthly benefit --	$ 60% of current income		
Partial disability covered?			
Residual disability covered?			
Cost-of-living rider?	no		
Guaranteed renewable?	yes		
Annual premium	$ 500	$	$

Medical Insurance

	Policy 1	Policy 2	Policy 3
Insured family members(s)	family		
Insurance company	RST Co.		

Medical Insurance (cont.)

	Policy 1	Policy 2	Policy 3
Group policy (yes or no)	yes		
Hospital expense insurance			
Daily room benefit	$ 150	$	$
Number of days	60		
Maximum miscellaneous expenses	$	$	$
Surgical expense insurance -- maximum Type of schedule	$50,000/occurrence	$	$
Major medical insurance			
Maximum limits			
Individual -- annual	$	$	$
lifetime	$	$	$
Family -- annual	$	$	$
lifetime	$ 250,000	$	$
Deductible individual	$	$	$
family	$ 200	$	$
Co-payment	20% of first $ 10,000	% of first $	% of first $
Annual premium	$ Employer	$	$
Dental Deductible	$	$	$
Co-payment	$	$	$
Maximum	$	$	$
Annual premium	$	$	$

Homeowners Insurance

	Property 1	Property 2	Property 3
Property address	123 Main	175 Riverview	
Insurance company	Acme	Acme	
Policy number	65431	54321	
Homeowners # (see exhibit 3-5B)	3	6	
Required co-insurance percent	80%	--%	
Cost to replace dwelling	$ 175,000	$	$
Coverage Dwelling	$ 140,000	$	$
Detached building	$ 14,000	$	$
Personal property	$ 70,000	$ 25,000	$
Additional living expenses	$ 28,000	$ 10,000	$
Personal liability	$ 100,000	$ 50,000	$
Medical payments to others	$ 10,000/person	$ 5,000/person	$
Personal property covered under personal article floaters (describe): __________	$	$	$
__________	$	$	$
__________	$	$	$
Personal property insured for replacement cost?			
Deductible	$ 250	$ 100	$
Annual premium	$ 800	$ 180	$

Automobile Insurance

	Vehicle 1	Vehicle 2	Vehicle 3
Description of vehicle	Toyota	Chevrolet	
Insurance company	Wheels Co.		
Policy number	A123	A123	
Named insured	Mark		
Other drivers	Judy		
Liability limits	$ 300,000	$	$
Bodily injury			
Each accident	$ 10,000	$	$
Each person	$	$	$
Property damage	$	$	$
Medical payments	$ 10,000	$	$
No-fault benefits	$	$	$
Uninsured motorist?	$ 30,000	$	$
Rental car coverage?	yes		
Collision -- deductible	$ 100	$	$
Comprehensive -- deductible	$ 100	$	$
Other ________			
Annual premium	$ 880	$	$

Umbrella Liability

	Policy 1	Policy 2	Policy 3
Insurance company			
Maximum coverage			

Umbrella Liability (cont.)

	Policy 1	Policy 2	Policy 3
Required basic auto liability coverage	$	$	$
Required basic homeowners liability coverage	$	$	$
Other required liability coverages (describe) ______________	$	$	$
Annual premium	$	$	$

Other Insurance

	Policy 1	Policy 2	Policy 3
Type of policy			
Covered property or liability			
Insurance company			
Policy number			
Limits Property	$	$	$
Liability	$	$	$
Annual premium	$	$	$

EXHIBIT 3/500-4

Risk-Management Checklist

Objective: To identify underinsured or uninsured risks.

Name ______________________________ Date ____________________

Risks	Client's Insurance That Provides Coverage								No
	Homeowner	Auto	Umbrella	Life	Disability	Health	Business	Other	Coverage
Loss of Income									
During client's life	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
After client dies	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Business interruption	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Estate Liquidity									
Final expenses	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Estate taxes	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Administration	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Loss of Property									
Total loss	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Loss of use	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Repairs/replace	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Injury to Others									
Damage to property	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Damage to person	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Damage to reputation	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Illness/Injury of Family									
Catastrophic events	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Routine events	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Old-age needs	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Other Occurrences									
Boards of directors	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Professional liability	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Scheduled property	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
Inflation adjustment	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]

Instructions: Check the box to indicate that a risk is covered by an existing insurance policy. Compare the client's coverage or lack of coverage for each risk to the client's evaluation of that risk on exhibit 3-5D.1. Consider whether the client has adequate coverage or requires additional coverage.

EXHIBIT 3/500-5

Risk-Evaluation Form

Name ______________________________ Date ____________

	Probability of Occurrence						Financial Impact						
	High 5	Good 4	Avg 3	Low 2	Poor 1		High 10	Good 8	Avg 6	Low 4	Poor 2		Total
Risks													
Loss of Income													
During client's life	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
After client dies	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Business interruption	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Estate Liquidity													
Final expenses	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Estate taxes	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Administration	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Loss of Property													
Total loss	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Loss of use	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Repairs/replace	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Injury to Others													
Damage to property	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Damage to person	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Damage to reputation	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Illness/Injury of Family													
Catastrophic events	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Routine events	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Old-age needs	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Other Occurrences													
Boards of directors	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Professional liability	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Scheduled property	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____
Inflation adjustment	[ ]	[ ]	[ ]	[ ]	[ ]	+	[ ]	[ ]	[ ]	[ ]	[ ]	=	____

Instructions: For each risk, enter in the corresponding box the score of the column that describes the probability that the risk will occur. In addition, enter in the corresponding box the score of the column that describes the financial impact if the risk occurs. Enter the sum of the two numbers in the column headed "Total."

EXHIBIT 3/500-6

Illustrative Communication to the Client

Mr. and Mrs. M. Sample
Middletown, U.S.A.

Dear Mr. and Mrs. Sample:

We are pleased to have the opportunity to assist you in reviewing your personal risk management. Before we begin to discuss the data and recommendations, we would like to focus your attention on aspects associated with this information.

Prospective Financial Information

We have assembled from information provided by you the accompanying forecasted life insurance information. This forecasted information was prepared solely to help you and your insurance advisers develop your risk management plan. Accordingly, it does not include all disclosures required by the guidelines established by the American Institute of Certified Public Accountants for the presentation of a financial forecast. We have not compiled or examined the forecasted information and express no assurance of any kind on it. The forecasted financial information should not be used for any purpose other than developing your risk management plan. It may differ materially from actual results because events and circumstances frequently do not occur as expected.

For the Firm

August 25, 19XX

Mr. and Mrs. Mark Sample
Summary of Risk Management Recommendations
August 25, 19XX

This report summarizes various aspects of Mark and Judy Sample's risk management plan. At the initiation of this engagement, you indicated that you were concerned about whether you had adequate insurance to protect your family from major losses or expenses. To address that concern, you requested that we assist you in developing a risk management plan. Our recommendations are summarized below.

Life Insurance

The life insurance recommendations are based on the following significant assumptions that you concluded are the most likely assumptions based on currently available information:

1. Average inflation during your lifetime will be 5 percent a year.

2. Average return on investments will be 7 percent a year before tax.

3. Annual living expenses in today's dollars will be $80,000 if Mark dies and $90,000 if Judy dies.

4. Judy plans to retire in 33 years.

5. You need a fund for the children's education of $46,000 in today's dollars.

Mark has $150,000 of life insurance at the present time. To provide for the family's needs in the event of his premature death, he should have approximately $1 million of additional insurance. This amount could be reduced if you decide not to fund certain needs with life insurance. For example, you could purchase $150,000 less insurance if you decide not to fund Judy's retirement needs.

Because about half of that life insurance need is temporary, needed only until the children are no longer dependents, you may want to consider a renewable term policy for that amount. A universal life policy for the remaining amount might also provide funding for Lauren and David's college education, because such policies usually permit cash withdrawals or loans.

It appears that the insurance on Judy's life is unnecessary and could be discontinued. Because the total premiums paid are more than the cash value and because the earnings rate on the policy is so low, we recommend you surrender the policy.

Disability Insurance

The amount of Mark's disability insurance seems adequate but we would recommend a cost of living rider and residual disability coverage. With a cost of living rider, the benefits are linked to an index and increase during the period of disability. Residual disability coverage provides benefits during a period of partial disability which follows a period of total disability.

Property and Liability Insurance

Your homeowners policy appears adequate because it covers 80 percent of your home's replacement cost. A rider may be needed, however, to cover Judy's doll collection.

You may want to increase the deductibles on both your homeowners and automobile policies to reduce the insurance cost.

A comprehensive personal liability policy can extend the liability coverages of your homeowners and automobile insurance policies to $5 or $10 million. Such a policy may cost a few hundred dollars, but would protect the family from bankruptcy in the event of a large loss. Comprehensive personal liability policies cover liabilities over certain amounts. It is important to determine that your basic homeowners and automobile policies provide liability coverage equal to such amounts to avoid gaps in coverage. You should consider purchasing directors' and officers' liability coverage because of your position on ABC Corporation's Board of Directors. In addition, your rodeo hobby increases your personal liability exposure.

Your sailboat may not be covered under any of your existing policies. You may need to purchase separate coverage for damage or liability related to it.

Health Insurance

Although your routine medical care appears adequately covered, the $250,000 lifetime limit could prove to be totally inadequate. You should explore the possibility of obtaining additional major medical coverage. Your policies do not include dental coverage, which could be a significant expense.

Periodic Updates

Actual insurance needs may differ materially from these projected needs because events and circumstances frequently do not occur as expected. In addition, changes in your personal situation, the economy, available insurance coverage, and other circumstances could modify the appropriateness of the recommendations. Consequently, we suggest that you schedule periodic reviews of your risk management situation to evaluate whether your insurance coverage is adequate.

EXHIBIT 3/500-7

LIFE INSURANCE INVENTORY

CLIENT NAME ______________
SPOUSE NAME ______________

	Insurance Company	Type of Policy	Policy Number	Register Date	Death Benefit	Asset Value	Policy Loan	Annual Value	Cash Increase	Annual Premium	Annual Dividend
NAME:											
1.	______	______	______	______	______	______	______	______	______	______	______
2.	______	______	______	______	______	______	______	______	______	______	______
3.	______	______	______	______	______	______	______	______	______	______	______
4.	______	______	______	______	______	______	______	______	______	______	______
			TOTALS	______	______	______	______	______	______	______	______

Total Asset Value - Client and Spouse ______________
Total Policy Loans - Client and Spouse ______________
Total Annual Cash Value Increase ______________
Total Family Premium ______________
Total Annual Dividends ______________

BENEFICIARIES OF POLICIES

	PRIMARY BENEFICIARY	SECONDARY BENEFICIARY	POLICY FEATURES	LOAN RATE
1.	______________	______________	______________	______________
2.	______________	______________	______________	______________
3.	______________	______________	______________	______________
4.	______________	______________	______________	______________
5.	______________	______________	______________	______________

Source: Baldwin, Ben G., *The Complete Book of Insurance*, Chicago: Probus Publishing Company, 1989, page 113.

EXHIBIT 3/500-8

Life Insurance-Needs Worksheet

Objective: To determine if the client needs additional life insurance.

Client ______________________________ Date ____________

Note: All amounts should be in current dollars unless indicated otherwise.

	Decedent: Husband	Decedent: Wife	Reference
1. Cash needs			
a. Estate-clearance fund			Exhibit 3-9F
b. Emergency fund			
c. Debt repayment at death			
d. Education fund			Exhibit 3-7D
e. Other ____________			
f. Total cash needs			
g. Cash needs not to be funded			Schedule C
h. Cash needs to be funded [line 1(f) less line 1(g)]			
2. Resources			
a. Liquid assets			Exhibit 3-2G
b. Assets convertible into cash [exclude investments reserved for retirement on exhibit 3-8G (line 4(c) below)]			
c. Life insurance			
d. Total liquid and cash resources			
3. Net cash needs (excess) [line 1(h) less line 2(d)]			
4. Income-continuation needs			
a. Until youngest is 18			Schedule A
b. Balance of years until retirement			Schedule B
c. Retirement years			Exhibit 3-8G, line 15
5. Additional life insurance indicated [add lines 3, 4(a), 4(b), and 4(c)]			
6. Income-continuation needs not to be funded			Schedule C
7. Additional life insurance needed (line 5 less line 6)			

Schedule A Income Continuation Until Youngest Child is Eighteen

	Decedent: Husband	Decedent: Wife	Reference
1. Years until youngest child is 18 years old			
2. Estimated average inflation rate during lifetime			
3. Estimated average before-tax return on investments			
4. Estimated annual living expenses			Exhibit 3-3A or 3-3B
a. Adjust for decedent's expenses included on line 4			
b. Adjust line 4 for increases in family expenses, including increases in day care expenses			
c. Adjusted annual living expenses: Line 4 minus line 4(a) plus line 4(b)			
d. Gross-up the annual living expenses on line 4(c) for taxes: divide the amount on line 4(c) by [1.00 minus the estimated average tax rate for this period]			
5. Annual resources			
a. Surviving spouse's earnings			
b. Children's social security			
c. Other income ________			
d. Total			
6. Annual amount required (excess) [line 4(d) less line 5(d)]			

7. Compute the inflation-adjusted rate of return during the period:

$$\left[\frac{1 + \text{interest rate on line 3}}{1 + \text{interest rate on line 2}} - 1\right] \times 100$$

	______	______	______

8. Amount needed to fund annual amount required: Multiply line 6 times the present value of an annuity factor for the number of years on line 1 at the interest rate on line 7. (See table 3 in the unit 3 appendix and interpolate or use a financial calculator.) ______ ______ To page 1, line 4(a)

Schedule B Income Continuation for Balance of Years Until Retirement

	Decedent: Husband	Decedent: Wife	Reference
1. Years until retirement			
2. Estimated annual living expenses			Exhibit 3-3A or 3-3B
a. Adjust for decedent's and childrens' expenses on line 2			
b. Other adjustments			
c. Adjusted annual living expenses: Line 2 minus line 2(a) plus <minus> line 2(b)			
d. Gross-up the annual living expenses on line 2(c) for taxes: Divide the amount on line 2(c) by [1.00 minus the estimated average tax rate for this period]			

3. Annual resources			
a. Surviving spouse's earnings	______	______	______
b. Other ______	______	______	______
c. Total resources	______	______	______
4. Annual amount required (excess) [line 2(d) less line 3(c)]	______	______	______
5. Compute the future value of the amount on line 4 in the number of years on schedule A, line 1, at the expected average inflation rate on schedule A, line 2. (See table 2 in the unit 3 appendix.)	______	______	______
6 Amount needed to fund the annual amount required: Multiply line 5 times the present value of an annuity factor for the number of years (line 1 less schedule A, line 1) at the interest rate on schedule A, line 7. (See table 3 in the unit 3 appendix and interpolate or use a financial calculator.)	______	______	______
7. To determine the lump sum required today, compute the present value of the amount on line 6 in the number of years on schedule A, line 1 at the interest rate on schedule A, line 3. (See table 1 in the unit 3 appendix.)	______	______	To page 1, line 4(b)

Schedule C Life Insurance Needs Adjustment

List below the life insurance needs from page 1 that will not be funded and the reasons why	Amount	Explanation
Cash needs		
________	____	________
________	____	________
________	____	________
________	____	________
Total cash needs not funded	____	To page 1, line 1(g)
Income continuation needs		
________	____	________
________	____	________
________	____	________
________	____	________
Total income continuation needs not funded	____	To page 1, line 6

EXHIBIT 3/500-9

Life Insurance-Needs Worksheet

Objective: To determine if the client needs additional life insurance.

Client Mark and Judy Sample Date 1/10/19X1

Note: All amounts should be in current dollars unless indicated otherwise.

	Decedent: Husband	Decedent: Wife	Reference
1. Cash needs			
a. Estate-clearance fund	14,000	14,000	Exhibit 3-9F
b. Emergency fund	0	0	
c. Outstanding debt	0	0	
d. Education fund	45,931	47,313	Exhibit 3-7D
e. Other ________			
f. Total cash needs	59,931	61,313	
g. Cash needs not to be funded			Schedule C
h. Cash needs to be funded [line 1(f) less line 1(g)]	59,931	61,313	
2. Resources			
a. Liquid assets	25,000	25,000	Exhibit 3-2G
b. Assets convertible into cash [exclude investments reserved for retirement on exhibit 3-8G (line 4(c) below)]	50,000	50,000	
c. Life insurance	150,000	50,000	
d. Total liquid and cash resources	225,000	125,000	
3. Net cash needs (excess) [line 1(h) less line 2(d)]	(165,069)	(63,687)	
4. Income-continuation needs			
a. Until youngest is 18	555,647		Schedule A
b. Balance of years until retirement	372,448		Schedule B
c. Retirement years	148,800		Exhibit 3-8G, line 15
5. Additional life insurance indicated [add lines 3, 4(a), 4(b), and 4(c)]	911,826	N/A	
6. Income-continuation needs not to be funded			Schedule C
7. Additional life insurance needed (line 5 less line 6)	911,826		

Schedule A Income Continuation Until Youngest Child is Eighteen

	Decedent: Husband	Decedent: Wife	Reference
1. Years until youngest child is 18 years old	16	16	
2. Estimated average inflation rate during lifetime	5%	5%	
3. Estimated average before-tax return on investments during lifetime	7%	7%	
4. Estimated annual living expenses			Exhibit 3-3A or 3-3B
a. Adjust for decedent's expenses included on line 4			
b. Adjust line 4 for increases in family expenses, including increases in day care expenses			
c. Adjusted annual living expenses: Line 4 minus line 4(a) plus line 4(b)			
d. Gross-up the annual living expenses on line 4(c) for taxes: Divide the amount on line 4(c) by [1.00 minus the estimated average tax rate for this period]	80,000	90,000	
5. Annual resources			
a. Surviving spouse's earnings	25,000	140,000	
b. Children's social security	14,400	8,000	
c. Other income ________________			
d. Total	39,400	148,000	
6. Annual amount required (excess) [line 4(d) less line 5(d)]	40,600	N/A	

7. Compute the inflation-adjusted rate of return during the period: $\left[\frac{1 + \text{interest rate on line 3}}{1 + \text{interest rate on line 2}} - 1\right] \times 100$	1.9		
8. Amount needed to fund annual amount required: Multiply line 6 times the present value of an annuity factor for the number of years on line 1 at the interest rate on line 7. (See table 3 in the unit 3 appendix and interpolate or use a financial calculator.)	555,647	--	To page 1, line 4(a)

Schedule B Income Continuation for Balance of Years Until Retirement

	Decedent		
	Husband	Wife	Reference
1. Years until retirement	33		
2. Estimated annual living expenses			Exhibit 3-3A or 3-3B
a. Adjust for decedent's and children's expenses on line 2			
b. Other adjustments ______________			
c. Adjusted annual living expenses: Line 2 minus line 2(a) plus <minus> line 2(b)			
d. Gross-up the annual living expenses on line 2(c) for taxes: Divide the amount on line 2(c) by [1.00 minus the estimated average tax rate for this period]	60,000		

3. Annual resources			
a. Surviving spouse's earnings	25,000		
b. Other ________			
c. Total resources	25,000		
4. Annual funds required (excess) [line 2(d) less line 3(c)]	35,000		
5. Compute the future value of the amount on line 4 in the number of years on schedule A, line 1, at the expected average inflation rate. (See table 2 in the unit 3 appendix.)	76,300		
6. Amount needed to fund the annual funds required: Multiply line 5 times the present value of an annuity factor for the number of years (line 1 less schedule A, line 1) at the interest rate on schedule A, line 7. (See table 3 in the unit 3 appendix and interpolate or use a financial calculator.)	1,099,640		
7. To determine the lump sum required today, compute the present value of the amount on line 6 in the number of years on schedule A, line 1 at the interest rate on schedule A, line 3. (See table 1 in the unit 3 appendix.)	372,448		To page 1, line 4(b)

EXHIBIT 3/500-10

LIFE INSURANCE NEEDS ANALYZER
FUNDS REQUIRED FOR CASH EXPENSES AND SINKING FUNDS

Probate and administration expenses:		
Percent of probate property		________
Percent for complexity		________
Funeral expenses	________	
Special obligations	________	
Pledges	________	
Contracts	________	
Divorce	________	
Business	________	
Debts/Insurance loans/Current bills		________
Income tax liabilities:		
Year of death return		________
Retirement plan pay out		________
IRA/KEOGH/TSA		________
Deferred annuity		________
Tax shelter - Liability exceeds:		
Basis		________
Fair market value		________
Federal estate taxes		________
State inheritance taxes		________
Education fund (Calculated or today's cost estimate)		________
Mortgage		________
Extra fund for error/Family emergency fund		________
FUNDS REQUIRED FOR CASH EXPENSES and SINKING FUNDS		________

Source: Baldwin, Ben G., *The Complete Book of Insurance*, Chicago: Probus Publishing Company, 1989, page 117.

EXHIBIT 3/500-11

CAPITAL NEEDS ANALYSIS

CASH NEEDS			
Mortgages and other loans payable		$150,000	
Funeral and estate administrative expenses		25,000	
Income taxes payable		10,000	
Education funding		75,000	
Emergency fund		25,000	
Total Cash Needs			$285,000
INCOME NEEDS			
Assumptions			
After tax rate of return	7.00%		
Inflation rate	5.00%		
Life expectancy	30 years		
Monthly income for life	$4,000		
Investment required today to meet inflation = adjusted monthly income for life			$ 1,098,000
TOTAL NEED			$1,383,000
LESS			
Capital available			
Cash and money markets		$75,000	
Investments		250,000	
Retirement plans		450,000	
Total Liquid Capital			$775,000
Existing life insurance			
Individually owned		$250,000	
Employer provided		50,000	
Total life insurance			$300,000
Total capital available			1,075,000
SURPLUS/(NEED)			$(308,000)

EXHIBIT 3/500-12

SURVIVOR INCOME FUNDS

	Number of Children	Years of Income	Monthly Income
Income Periods:			
Children under 18	_______	_______	_______
Children over 18	_______	_______	_______
Spouse under 60/65	_______	_______	_______
Spouse Age 60/65			
For Life (Recommend age 85)	_______	_______	_______

Period 1 Income Objective _______
Less: Estimated Social Security _______ *
Spouse's Earned Income _______
Other Assured Income _______
Net Unfunded Income Objective _______ per month
Discounted Present Value for 0 years ________________
assuming __% interest $0 Child - Raising Fund
*(ROT = Social Security Benefits, $300 per Eligible beneficiary, maximum 3)

Period 2 Income Objective _______
Less: Estimated Social Security _______ *
Spouse's Earned Income _______
Other Assured Income _______
Net Unfunded Income Objective _______
*(ROT - Social Security Benefits STOP)

Discounted Present Value for ____ years ________________
assuming _____ years Post children Fund

Period 3 Income Objective
Less: Estimated Social Security _______
Spouse's Earned Income _______*
Other Assured Income _______
IRAs & Other Ret. Plans _______
Net Unfunded Income Objective _______ per month
*(ROT = Social Security Benefits, $600 per month)

Discounted Present Value for ______ years ________________
assuming ______% interest. Retirement Fund

ANNUITY METHOD FOR INCOME IN THE EVENT OF DEATH $______
(Principal ZERO ($0) at Spouse's Life Expectancy)
ALTERNATIVE METHOD - CAPITAL RETENTION METHOD
ASSUMING _____ PERCENT INTEREST $______
(Principal _______ at Spouse's Life Expectancy) $______

TOTAL FAMILY CAPITAL REQUIRED FOR EXPENSES & INCOME: ANNUITY OR CAPITAL LESS:
Present Family Investment Capital ______
Existing Net Benefits of Life Ins. ______
Retirement Plan Generated Cash ______
- ______ - ______

ADDITIONAL FAMILY CAPITAL REQUIRED*
or (Surplus) Family Capital Available. ANNUITY __________ CAPITAL __________

*Note: Additional Life Insurance of this amount, assuming ______% interest, would create sufficient dollars for your estate to accomplish all of your stated family objectives.

Source: Baldwin, Ben G., *The Complete Book of Insurance*, Chicago: Probus Publishing Company, 1989, page 132.

EXHIBIT 3/500-13

Analysis of Life Insurance Products

Kind	General Description	Investment Vehicle	Investment Flexibility	Premium Flexibility	Face Amount Flexibility
Nonguaranteed term	Lowest cost coverage possible	None	Not applicable	None; increases yearly	None
Yearly renewable term	Quality term	None	Not applicable	None; increases yearly	None
Whole life	Basic coverage, may pay dividends	Insurer-selected long-term bonds and mortgages	None, except by borrowing from policy to reinvest	None, although dividends may reduce or eliminate premium, and loans are available	None; added coverage requires new purchase and physical
Universal life	Coverage with flexibility in premiums and face amount	Annual interest-sensitive investments	None, except by withdrawal of capital	Maximum, ranging from enough for mortality and expenses on up	Much; increased or decreased to suit insured's life setting, although major increases require good health
Variable life	Coverage with flexibility in investment instruments	Common stock; bond funds; guaranteed-interest rate funds; zero-coupon bonds; money market instruments, etc.	Maximum, with insured directing investment activity	None, although loans are available	None; added coverage requires new purchase and physical
Universal variable life	Coverage with flexibility in investment instruments, premiums and face amount	Common stock; bond funds; guaranteed-interest rate funds; zero-coupon bonds; money market instruments, etc.	Maximum, with insured directing investment activity	Maximum, ranging from enough for mortality and expenses on up	Much; increased or decreased to suit insured's life setting, although major increases require good health

Source: Adapted from the Baldwin Financial Systems Product Analyzer. Northbrook, IL: Baldwin Financial Systems, Inc., 1986. Used with permission.

EXHIBIT 3/500-14

IMMEDIATE ANNUITY ACTION LETTER

Dear____________:

I am considering the purchase of a single-premium immediate fixed/variable annuity contract. The annuitant is a male/female born_____________. I also would like a quote on a male/female born___________.

In addition to the above quotes, I would like a quote on a joint life annuity for a male/female born__________and a male/female born__________. I, and the other individuals involved, am a resident of the state of __________and our combined marginal state and federal income tax bracket is _____ percent. Please base your quotes on a single consideration of $____________ and/or a monthly income of $___________.

The monies that I would be investing in this immediate annuity contract come from my personal funds/IRA funds/TSA funds/lump sum distribution from an employer's qualified retirement plan or __________. For quote purposes, please assume the insurance company would receive the investment by ______ (date). I would ask that my monthly payments begin ______ (date). (This date must be at least one month after the date that the insurance company receives the proceeds.)

Please provide me with quotes from _____________ (number of) insurance companies and send a Best's rating report on each insurance company that is providing a quote.

Mail the information to me at the following address. I will call you with my questions after I have reviewed the information. If you have any questions, please call me at __________________.

Thank you very much for your assistance.

Sincerely,

Name
Address
Phone Number

Adapted from: Ben G. Baldwin, *The Complete Book of Insurance* (Chicago: Probus Publishing Company, 1989) 224.

EXHIBIT 3/500-15

DEFERRED/ACCUMULATION ANNUITY REQUESTS

Dear__________:

I am considering investing in a deferred annuity. I would prefer an annuity contract that allows me the personal convenience of investing when funds become available. I would prefer not to purchase a contract that makes investment in the contract mandatory over some predetermined time. I would prefer not to accept the restriction imposed by a single-premium deferred annuity contract unless the contract would offer superior returns or features different from those available in a flexible premium annuity contract. For quote purposes, please use $_________ as my initial investment in the contract.

Please provide an explanation of any and all charges that will be made against my investment and the net amount that will work for me in the annuity contract. Also, please indicate any surrender charges or contingent withdrawal fees that I could incur should I cash in the annuity contract. In addition, please give the period over which these charges will be applicable.

I am favorably disposed toward variable annuity contracts as long as there is a safe-haven account available within the contract. Please indicate which account is a safe-haven account and what guarantees of principal and interest are available within that account. I would also like to know if there are any restrictions on my movement into or out of any accounts during the life of the annuity contract. Please provide me with the prospectus and all other available information about the accounts within the contract.

I would like an annuity contract from a quality company with low expense and sales charges. I would prefer surrender charges to front-end sales charges so that all of my money would go to work for me immediately and so that, if I maintain my contract until after the surrender charge period, I would never have to pay such sales charges. I would like maximum flexibility, a good safe-haven account providing interest and principal guarantees, and good-performing, alternative mutual fund types of accounts. I seek flexibility and convenience of investment and frequent and convenient reporting regarding account balances. I would like to be able to switch between the various accounts at my convenience, preferably by telephone.

At this time, it is my intention to defer the annuity for as long a period as possible, so please let me know at what age the insurance company insists that I begin to take funds. I would like to avoid forced annuitization for as long as possible. Please state explicitly any penalties I could be exposed to if I chose never to annuitize my contract. Please send the requested information to me at the address below. Call me if there is anything else you need to know to provide me with the information.

Thank you for your assistance.

Sincerely,

Name
Address
Phone

Adapted from Ben G. Baldwin, *The Complete Book of Insurance*, (Chicago: Probus Publishing Company, 1989), 226.

EXHIBIT 3/500-16

FIXED ANNUITY COMPARISON CHART

	Company 1	Company 2	Company 3
NAME OF COMPANY:	________	________	________
RATINGS:			
A.M. Best	________	________	________
Other rating	________	________	________
RATES:			
Initial interest rate	________	________	________
Compounded yield	________	________	________
Initial rate guarantee period	________	________	________
Bailout rate	________	________	________
Minimum guaranteed rate	________	________	________
WITHDRAWAL CHARGES:			
Early withdrawal period	________	________	________
Withdrawal charge	________	________	________
Annual withdrawal privilege	________	________	________
Annual administrative fee	________	________	________
MINIMUM INVESTMENTS:			
Qualified plans	________	________	________
Nonqualified plans	________	________	________
Additional deposits	________	________	________
Commission	________	________	________
How many other annuities are offered by this insurer?	________	________	________
Additional comments:	________	________	________

EXHIBIT 3/500-17

MEDICAL AND DENTAL INSURANCE INVENTORY

	Insured	Policy Company	Policy Number	Maximum	Deductible	Coin-surance	Stop-Loss	Remarks
1.	________	________	________	________	________	________	________	________
2.	________	________	________	________	________	________	________	________
3.	________	________	________	________	________	________	________	________
4.	________	________	________	________	________	________	________	________
5.	________	________	________	________	________	________	________	________

Total Annual Family Premium: $____________

Adapted from: Baldwin, Ben G., *The Complete Book of Insurance*, (Chicago: Probus Publishing Company, 1989), 66.

EXHIBIT 3/500-18

HEALTH INSURANCE CLIENT MODEL INFORMATION LETTER

Dear____________:

I am working with my CPA, __________ (name) to evaluate my medical insurance, and I would appreciate your assistance. I have listed below the specific information I need. Please supply the requested information on this letter and return it to me.

1. Maximum limit on total benefit payments ____________________________

2. Individual deductible amount ______________________________________

3. Limit on deductible for a family ___________________________________

4. Coinsurance provision: I pay ____________________________________
   Insurance company pays ____

5. Stop-loss provision: per individual _______________________________
   per family ____

6. Duration of stop-loss ____

7. Any interior limits that I should consider? ____________________

Please send copies of any descriptive material you have on the plan along with claim forms and instructions.

I would appreciate your evaluation for this coverage including whether (1) it is sufficiently comprehensive to provide for my family and (2) it is fairly priced. I would appreciate any recommendations you might have for improvement.

It has come to my attention that the quality of nursing home policies and the cost of that coverage has improved significantly in the last few years. Could you let me know if you have this coverage available, and whether you would recommend it for my consideration?

I look forward to hearing from you. Thank you for your assistance.

Sincerely,

Client's name
Address

Adapted from: Baldwin, Ben G., *The Complete Book of Insurance*, Chicago: Probus Publishing Company, 1989, page 58.

EXHIBIT 3/500-19

MODEL LETTER TO BE USED BY CLIENT SEEKING INFORMATION ABOUT LONG-TERM CARE

Dear_________:

I am working with my CPA and we need your assistance. I am looking for a quality nursing home policy and would appreciate it if you could provide us with quotes and information.

I was born ____________, and am a male/female, smoker/nonsmoker in good health. My spouse was born _____________, and is a male/female, smoker/nonsmoker, also in good health.

I would like quotes on guaranteed renewable long-term care policies providing benefits of $100 per day after an elimination period of twenty days, for a benefit period of at least five years. I would like to have the benefits payable regardless of whether the nursing home I use is classified as a skilled, intermediate care, respite, or custodial care home. I would like to have benefits payable if the required personal care is provided in our own home or in an adult day-care center. I wish to avoid any policies that have exclusions for Alzheimer's disease or organic brain disease of any sort, and policies that include pre-entry requirements such as the three-day hospitalization requirement.

I would like to know of limitations for any preexisting condition, and the requirements for application. I would appreciate your recommendations about any supplemental benefits the policy should contain, such as an inflation rider.

Please call me if you have any questions. I look forward to receiving your proposals in writing so that I can review them with my adviser. We may then ask you to meet with us to respond to our questions. Thank you for your assistance.

Sincerely,

Client Name & Address

____

____

Adapted from: Baldwin, Ben G., *The Complete Book of Insurance*, Chicago: Probus Publishing Company, 1989, page 42.

EXHIBIT 3/500-20

DISABILITY POLICY CHECKLIST

Feature	Recommendation	Your Policy	Annual Premium Cost
Basics:			
Monthly income	The maximum you can get	______	$______
Definition of Disability	Own occupation if you can get it	______	______
Guaranteed Renewable	Yes	______	______
Noncancelable	Yes	______	______
Benefit period	As long as you can get	______	______
Waiting period	60 to 90 days	______	______
Options:			
Residual disability	Yes	______	______
Partial disability	Yes	______	______
COLA	Yes	______	______
Social Security	Yes	______	______
Additional purchase option	Yes	______	______
Total Premium			$______

Adapted from: Virginia Applegarth, *How to Protect Your Family with Insurance* (Boston: Houghton Mifflin Company, 1990) 38.

EXHIBIT 3/500-21

INVENTORY OF CLIENT'S CURRENT COVERAGE

Disability Insurance Inventory

	Company/ Insured	Policy Number	Monthly Income	Benefits Start	Benefits End	Annual Premium	Features of Disability (circle as many as possible)
1.	______	_____	______	_______	_______	______	1 2 3 4 5 6 7 8 9 10
2.	______	_____	______	_______	_______	______	1 2 3 4 5 6 7 8 9 10
3.	______	_____	______	_______	_______	______	1 2 3 4 5 6 7 8 9 10

Total: $______ Total: ______

70 percent of my gross monthly earned income is $______________________________.

FEATURES OF DISABILITY

1. Personal Policy
2. Noncancelable and Guaranteed Renewable
3. Your Own Occupation
4. Group Policy
5. Association Policy
6. Any Occupation
7. Partial Disability
8. Residual Disability
9. Guaranteed Insurability
10. Inflation Rider

Adapted from: Ben G. Baldwin, *The Complete Book of Insurance* (Chicago: Probus Publishing Company, 1989) 31.

EXHIBIT 3/500-22

MODEL LETTER FOR A CLIENT WHO WANTS INFORMATION ABOUT DISABILITY INCOME

Dear___________:

I am working with my CPA, (name), to evaluate my disability income insurance. I would appreciate your assistance.

In the event of my disability, it is my objective to have disability income benefits of approximately 60 to 70 percent of my income, payable for as long a period as possible, with the strongest definition of disability available. The policy must insure me within my occupational specialty for the duration of the benefit period.

I would appreciate a quote for quality individual, noncancelable, guaranteed renewable coverage in the amount of $_________ per month for the longest payment period possible, preferably for life. Please provide quotas for waiting periods of 30, 60, 90, 180 and 270 days, with both a step rate and level premium plan, if available. Please include in your quote any supplemental benefits you would recommend for me along with descriptive material and premiums.

Please mail the proposals to me from _____ quality companies. I would appreciate your recommendations of the policy you think best suits my needs.

Please call me at _________ if you have questions.

Sincerely,

(Client's signature and return address.)

Adapted from: Ben G. Baldwin, *The Complete Book of Insurance* (Chicago: Probus Publishing Company, 1989) 33.

EXHIBIT 3/500-23

DISABILITY INCOME REQUIREMENTS

In the event a client and spouse, or both, become disabled, their living expenses would not be the same as they presently are. Some expenses would increase, such as health care costs and disability related expenses, while some would decrease, such as savings and investment, income taxes and luxury spending.

The CPA should consider collecting the following information to allow estimating the adjustments that would have to be made to the client's projected use of funds in the event of disability.

<u>Expected Sources and Amounts of Income if:</u>

_________ is disabled		Spouse _________ is disabled	
Disability income/sick pay	$______	Disability income/sick pay	$_____
Interest/dividend income	_______	Interest/dividend income	______
Spouse's employment	_______	Spouse's employment	______
Other	_______	Other	______
Total nonwork sources	_______	Total nonwork sources	______
Total income	$______	Total income	$_____

Social Security benefits are not included. Social Security usually pays only if the disability is very severe. Because in recent years Social Security has been more rigid in the standards it applies before it grants benefits, most CPAs consider it unwise to depend on Social Security for disability income planning purposes.

EXHIBIT 3/500-24

HOMEOWNERS INSURANCE POLICY CHECKLIST

Feature Cost	Recommendation	Client's Policy	Annual Premium
Type:			
HO-1, HO-2, HO-3 HO-4, HO-6, HO-8	See text, based on client's type of home	______	$______
Value of home	100 percent of replacement cost	______	______
Coverages:			
Property insurance	Replacement cost	______	______
Personal property	Replacement cost	______	______
Liability insurance	$300,000+	______	______
Deductibles	Highest client can afford	______	
Total premium			$______

Adapted from: Virginia Applegarth, *How to Protect Your Family with Insurance* (Boston: Houghton Mifflin Company, 1990) 75.

EXHIBIT 3/500-25

MODEL LETTER FOR HOMEOWNERS INSURANCE CLIENT INFORMATION

Dear ______________________________:

Please provide me with a quote for homeowners insurance coverage based on the following information.
I want to:

1. Maintain my liability protection at the maximum amount available or at an amount that would best coordinate with an umbrella personal liability policy.
2. Make sure that the coverage is of the comprehensive all-risk variety. I would like the most comprehensive, including coverage for personal property losses and indirect losses resulting from the loss of use of personal property.
3. Be covered for losses on a *replacement-cost* basis rather than an *actual-cash-value/depreciated-value* basis for all coverage including personal property.
4. Determine if there are any discounts available for the following:

	I have	I do not have
Smoke detectors	_____	___________
Fire extinguishers	_____	___________
Deadbolt locks	_____	___________
Other protective devices	_____	___________

5. Determine whether special coverage for household domestic help and other occasional workers hired for household work is needed.
6. Receive your recommendations on cost-effective deductibles.
7. Maximize guest medical.
8. Receive your recommendations regarding my need for earthquake and flood coverage and the cost of the coverage.
9. Determine whether I have coverage for sewer backup and sump-pump failure.
10. Receive your recommendation on my need for any business pursuits endorsements.

Special items of value that I think need to be considered on a personal property rider are as follows:

Item	Value	Appraisal Method/Date
______________	____________	_________________
______________	____________	_________________

Enclosures: Copy of declarations page of existing homeowners insurance policy.

Adapted from: Ben G. Baldwin, *The Complete Book of Insurance* (Chicago: Probus Publishing Company, 1989) 70.

EXHIBIT 3/500-26

HOMEOWNERS COVERAGE - SECTION I

	100% Dwelling Coverage A	10% of Other Structures Coverage B	50% of Personal Property Coverage C	20% of Loss of Use Coverage D
HO-1	Basic	Basic	Basic	Basic (10 % of A)
HO-2	Broad	Broad	Broad	Broad
HO-3	All risk	All risk	Broad (HO-15 converts to All Risk)	All risk
HO-4 (for renters)	Not applicable	Not applicable	Broad (basic coverages)	Broad (20% of C)
HO-6 (for condominiums/ cooperatives)	Not applicable	Not applicable	Broad	Broad (40% of C)
HO-8 (for properties not qualifying for HO-1 through HO-3)	Basic	Basic	Basic	Basic

Source: Ben G. Baldwin, *The Complete Book of Insurance,* (Chicago: Probus Publishing Company, 1989) 75.

EXHIBIT 3/500-27

Homeowners Policies

	Homeowners 1 (Basic Form)	Homeowners 2 (Broad Form)	Homeowners 3 (Special Form)	Homeowners 4 (Contents Broad Form)	Homeowners 6 (Unit Owners Form)	Homeowners 8 (Modified Average Form)
Remarks			Widely used	Renter's insurance	Condominium owner's insurance	Older home if replacement cost substantially exceeds market value
Covered property						
Dwelling	$15,000 minimum	$15,000 minimum	$20,000 minimum	--	--	$15,000 minimum
Other structures	10% of dwelling	10% of dwelling	10% of dwelling	--	--	10% of dwelling
Insured's personal property	50% of dwelling	50% of dwelling	50% of dwelling	$6,000 minimum	$6,000 minimum	50% of dwelling
Additional living expenses and fair rental value for loss of use	10% of dwelling	20% of dwelling	20% of dwelling	20% of personal property	40% of personal property	10% of dwelling
Covered risks	Named perils: fire, lightning, windstorm, hail, explosion, riot or civil commotion, aircraft, vehicles, smoke, vandalism or mali-	Same as HO-1, plus loss from falling objects; weight of ice, snow or sleet; accidental discharge or overflow of water or steam; sudden and accidental tearing, cracking,	Dwelling and other structures: all risks except those specifically excluded Personal property: same as HO-2, plus damage by glass that is part of	Same as HO-2 risks for personal property	Same as HO-2 risks for personal property	HO-1 risks with certain restrictions, such as theft coverage to apply only to losses on the residence premises up to $1,000 Claims limited

	Homeowners 1 (Basic Form)	Homeowners 2 (Broad Form)	Homeowners 3 (Special Form)	Homeowners 4 (Contents Broad Form)	Homeowners 6 (Unit Owners Form)	Homeowners 8 (Modified Average Form)
Covered risks (cont.)						
	cious mischief, theft, breakage of glass that is part of building ($100 limit), volcanic eruption	burning or bulging of a steam, hot water A/C, sprinkler system or water heater; freezing; sudden and accidental damage from artificially generated electrical current	building, storm door, or storm window			to amount required to repair or replace the property using common construction materials and methods
Other Coverages						
Personal liability	$100,000	$100,000	$100,000	$100,000	$100,000	$100,000
Medical payments to others	$1,000 for each person	$1,000 for each person	$1,000 for each person	$1,000 for each person	$1,000 for each person	$1,000 for each person

EXHIBIT 3/500-28

THE 80 PERCENT RULE FOR HOMEOWNERS LOSS SETTLEMENT

	Partial Loss	Total Loss
If house is insured to at least 80 percent of replacement cost	Full replacement	Full replacement (up to amount of policy)
If house is not insured to at least 80 percent of replacement cost	By Formula	To policy maximum

Source: Virginia Applegarth, *How to Protect Your Family with Insurance* (Boston: Houghton Mifflin Company, 1990) 73.

EXHIBIT 3/500-29

PERSONAL PROPERTY LIMITATIONS UNDER HOMEOWNERS POLICY

Item	*Indemnification*
Money, bank notes, coins, and metals	$ 200
Securities, manuscripts, stamp collections, and valuable papers	1,000
Watercrafts including their trailers, equipment, motors	1,000
Trailers	1,000
Grave markers	1,000
Loss of jewelry, watches, fur, and semiprecious stones by theft	1,000
Loss of firearms by theft	2,000
Loss of silverware, silver plate, Flatware, goldware, gold plate, and pewter	2,500
Property on the residence premises used for business purposes	2,500
Property away from the residence premises used for business purposes	250

Adapted from: Ben G. Baldwin, *The Complete Book of Insurance* (Chicago: Probus Publishing Company, 1989) 79.

EXHIBIT 3/500-30

MODEL LETTER FOR OBTAINING INFORMATION ON VEHICLE INSURANCE

Dear ______________________________:

I am reevaluating my vehicle insurance, and I would appreciate your assistance. My specific requests concerning my existing vehicle coverages are as follows. I want to:

1. Provide for the maximum available uninsured and underinsured motorist coverage.

2. Provide for the maximum available medical payments coverage.

3. Make collision and comprehensive insurance cost-effective by not providing collision coverage on a vehicle whose replacement cost is not cost-effective to insure. I would also like to use cost-effective deductibles. What changes would you recommend to bring my insurance into compliance with these two objectives?

4. Maintain my liability coverage at the maximum amount available or the amount that would best coordinate with other personal liability policies.

Please let me know if there are any other provisions, endorsements, or riders that can be added to my existing policy.

Sincerely,

(Client's signature and return address)

Enclosure:

Adapted from: Ben G. Baldwin, *The Complete Book of Insurance* (Chicago: Probus Publishing Company, 1989) 88.

EXHIBIT 3/500-31

AUTO INSURANCE POLICY CHECKLIST

Feature	Recommend	Client's Policy	Premium Cost
Bodily injury liability	$250/$500	____________	$________
Property damage	$100	____________	$________
Medical payments	$10,000	____________	$________
Uninsured/underinsured motorist	$250/$500	____________	$________
Physical damage:			
Collision	Highest deductible affordable	____________	$________
Comprehensive	Highest deductible affordable	____________	$________
Towing	Optional	____________	$________
Rental	Optional	____________	$________
Total premium			$________

Source: Virginia Applegarth, *How to Protect Your Family with Insurance* (Boston: Houghton Mifflin Company, 1990) 61.

EXHIBIT 3/500-32

MODEL LETTER FOR CLIENT INFORMATION ABOUT COMBINED VEHICLE, HOMEOWNERS, AND LIABILITY (UMBRELLA) POLICIES

Dear__________:

I am working with ______________ to evaluate my property casualty insurance and I would appreciate your assistance. My information needs concern insurance covering my vehicle (s), real property, or umbrella coverage.

Vehicle Insurance. My specific desires concerning my vehicle coverages are as follows:

1. To provide the maximum available uninsured and underinsured motorist coverage.
2. To provide the maximum available medical payments coverage.
3. To make collision and comprehensive insurance cost-effective by not providing collision coverage on a vehicle with a replacement cost of less than $________ and by using cost-effective deductibles.
4. To increase my liability coverage to the maximum practical limit, keeping in mind that I want to coordinate this coverage with my personal umbrella liability policy.

What changes would you recommend to bring my insurance into compliance with these objectives?

Homeowners Insurance. My specific desires concerning my homeowners coverage are as follows:

1. To increase my liability coverage to the maximum practical limit keeping in mind that I want to coordinate this coverage with my personal umbrella liability policy.
2. To make sure that my coverage is of the comprehensive all-risk variety, I would like the most comprehensive homeowners form including personal property losses and indirect losses resulting from the loss of use of personal property.
3. To make sure that loss payments are made on a replacement-cost basis rather than an actual-cash-value/depreciated-value basis.
4. To receive any discounts available for:

	I have	I do not have
Smoke detectors	____________	____________
Fire extinguishers	____________	____________
Deadbolt locks	____________	____________
Other protective devices	____________	____________

5. To determine whether I require any special coverages for my household domestic help or other occasional workers I hire for household work.

6. To determine the most cost-effective deductibles available.
7. To maximize guest medical payment coverage.
8. To determine the cost of earthquake and flood coverage. Your recommendation regarding my need for this coverage would be appreciated.

Special items of value that you should consider for inclusion on a personal property rider are:

Item	Value	Appraisal	Method/Date
________	$________	$________________________	
________	________	________________________	
________	________	________________________	
________	________	________________________	

Umbrella Insurance. My assets and income subject to attachment in the event of a successful damage claim being brought against me have a value of approximately $______. Your recommendation regarding my need for an umbrella liability insurance policy would be appreciated.

I am engaged in the following (professional/business) activities listed here. Would you recommend any business pursuits endorsements based on this information?

____

____

____

Sincerely,

(Client's signature and return address)

Adapted from: Ben G. Baldwin, *The Complete Book of Insurance* (Chicago: Probus Publishing Company, 1989) 108 - 109.

EXHIBIT 3/500-33

COMPREHENSIVE PERSONAL LIABILITY (UMBRELLA) MODEL POLICY LETTER

Dear__________:

I would appreciate it if you would give me a quote on a Comprehensive Personal Liability Policy for $1 million in coverage (cost: $_____). Does this coverage increase my existing vehicle and homeowners liability coverages? Does this coverage supplement my existing coverage by providing protection against certain liability exposures not covered under those policies, such as personal injury, invasion of privacy, and liability for most nonowned property in my care, custody, or control?

What would be the maximum I could purchase ($_________) and its cost ($________)?

I appreciate your prompt assistance with this matter.

Sincerely,

(Client's signature and return address)

Enclosures: Copies of declarations pages from current policies

Adapted from: Ben G. Baldwin, *The Complete Book of Insurance* (Chicago: Probus Publishing Company 1989) 109.

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