LIFE INSURANCE DUMP SHEET

Concepts, contracts, and basics

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General insurance concepts

- **Risk types**
  - **Pure**: Only loss possible; insurable. Insurance restores, it does not create profit (principle of indemnity).
  - **Speculative**: Loss or gain possible; not insurable (e.g., gambling, investing).
- **How to manage risk**
  - **Avoid**: Eliminate the risk entirely (e.g., don't drive).
  - **Reduce**: Lower the chance or severity of risk (e.g., healthy habits).
  - **Retain**: Accept and pay for the risk yourself (e.g., deductibles).
  - **Share**: Spread the risk with others (e.g., business partners).
  - **Transfer**: Shift the risk to another party (e.g., buying insurance).
- **Law of large numbers**
  - The larger the group, the more accurately insurers can predict losses and set premiums. It's the statistical foundation of insurance.
- **Insurable interest**
  - Must have a financial or personal stake in the insured at time of application (e.g., self, family, business).
- **Free look period**: Policy owners have at least 10 days (or as required by state law) to cancel a new policy and receive a full refund.

Insurance contracts

- **Four elements of a valid contract**
  - **Offer:** Made when the applicant submits the application (and usually the first premium); accepted when the insurer approves and issues the policy.
  - **Acceptance:** Acceptance occurs when the insurer agrees to the offer as written or with counter-offers.
  - **Consideration:** Consideration is the exchange of value – the applicant's premium for the insurer's promise to pay claims.
  - **Legal capacity and purpose:** Both parties must be legally able to enter the contract, and the purpose must be legal (no fraudulent intent).
- **Key features**
  - **Adhesion**: The insured cannot negotiate terms ("take it or leave it"). Any ambiguity is interpreted in favor of the insured.
  - **Aleatory**: Unequal value exchange (small premium for large benefit).
  - **Unilateral**: Only the insurer makes a binding promise (the insured does not promise anything in return).
  - **Conditional**: Terms and conditions must be met to receive benefits.
- **Utmost good faith**
  - Both parties must act honestly and rely on each other's representations.
- **Representations vs. warranties**
  - **Representation**: Statements believed to be true to the best of the applicant's knowledge.
  - **Warranty**: Guaranteed truth; false = void policy.
  - **Misrepresentation**: Knowingly false information may void the contract.
- **Doctrine of adhesion**
  - If contract terms are ambiguous, they are interpreted in favor of the insured.
- **Principle of indemnity**
  - Insurance restores the insured to their financial position before the loss; no opportunity for gain.

Life insurance basics

- **Types of policies**
  - **Term life**: Pure protection, no cash value, less expensive, premiums rise over time.
  - **Whole life**: Permanent, builds cash value, level premium.
  - **Universal life**: Flexible premiums and death benefit, builds cash value.
  - **Variable life**: Investments tied to a separate account. Policyholder bears the investment risk. Requires securities license to sell; regulated by SEC/FINRA. Cash value and death benefit can fluctuate based on investment performance.
- **Beneficiaries**
  - **Revocable**: Can be changed at any time.
  - **Irrevocable**: Cannot be changed without beneficiary's consent.
  - **Per stirpes**: Deceased beneficiary's share goes to their heirs.
  - **Per capita**: Proceeds divided only among surviving named beneficiaries.
- **Premium factors**
  - **Mortality**: The likelihood of death; higher for older individuals, increasing premium costs.
  - **Interest**: Insurer invests premiums to earn interest, which helps reduce the required premium.
  - **Expenses**: Operational costs (commissions, administration, profits) added to the premium.
- **Policy riders**
  - **Waiver of premium**: Waives premiums if the insured becomes disabled and cannot work.
  - **Guaranteed insurability**: Allows purchasing more insurance later, without proof of insurability.
  - **Accidental death benefit**: Pays extra if the insured dies due to an accident.
  - **Return of cash value**: Pays back the cash value of the policy in addition to the death benefit at death.
  - **Payor benefit**: Waives premiums on a juvenile life insurance policy if the parent or guardian paying the premiums dies or becomes disabled before the child reaches a certain age (usually 21 or 25). This keeps the child's policy in force without requiring further payments.
- **Policy provisions**
  - **Contestability period**: Insurer can void the policy for misrepresentation within the first 2 years.
  - **Suicide clause**: Suicide within 2 years results in premium refund only.
  - **Reinstatement**: Lapsed policies can be reinstated (typically within 3 years) with proof of insurability and back premiums plus interest.
  - **Misstatement of age**: If an insured misstates their age, the policy remains valid, but the face amount will be adjusted based on the correct age.
- **Group life insurance**
  - **Applicants**: Employers, METs, labor unions, creditors.
  - **Policy issuance**: One policy for the group, participants get certificates.
  - **Underwriting**: No medical exams for most groups; rates based on size, age, and claims.
  - **Cancellation**: Group policies may be canceled by the insurer or policyholder with 31 days' notice.
  - **Participation**: 100% for non-contributory, 75% for contributory.
  - **Conversion**: Members can convert to individual policy within 31 days without proof of insurability.
- **Annuities**
  - **Purpose**: Protects against outliving financial resources, provides guaranteed payments (often for life).
  - **Premiums**: Not tax-deductible but grow tax-deferred.
  - **Purchase**: Can be single premium (immediate) or periodic payments (deferred).
  - **Accumulation**: Flexible contributions, but withdrawals are taxable and subject to 10% penalty (if under 59½).
  - **Annuitization**: Converts the annuity to guaranteed periodic payments; irreversible.
  - **Payout options**
    - **Life income**: Guaranteed for life, ceases at death.
    - **Period certain**: Payments for life, but beneficiary continues if annuitant dies early.
    - **Refund**: Payments continue to beneficiary if the total payments are less than the contract value.
    - **Joint life**: Payments continue until the last annuitant dies.
  - **Taxation**: Payments taxed based on growth portion; no 10% penalty once annuitized.
  - **1035 Exchange**: Tax-free transfers allowed between life insurance and annuity contracts (e.g., life → life, life → annuity, annuity → annuity). Not allowed from annuity → life.
    - **ERISA**: ERISA governs retirement plans. Life insurance and annuities can work alongside retirement strategies but are not ERISA-qualified unless used in specific employer-sponsored plans.
- **Taxation basics**
  - **Premiums**: Not tax-deductible.
  - **Death benefits**: Usually tax-free to the beneficiary.
  - **Cash value**: Grows tax-deferred.
  - **Withdrawals**: Taxable only if they exceed the premiums paid (cost basis). In standard life insurance policies — as long as they are not MECs — premiums come out first, and interest is taxed only after the basis is withdrawn.
  - **Policy loans**: Not taxable if policy remains in force.
  - **Dividends**: Not taxable (considered return of excess premium).
  - **Modified Endowment Contract (MEC)**: A life policy that fails the 7-pay test; taxed like an annuity (LIFO, 10% penalty if under 59½).