Introduction

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Dollars and Sense

Chapter 1: The Reality

The Reality

Has retirement become impossible? With the stock market losses in 2008 and 2009 many people began to rethink their retirement age. Many of the recently retired returned to work, fearful that their diminished retirement funds could not support them for the twenty to thirty years they would spend in retirement. Those who planned to retire soon recalculated their retirement age and chose to remain employed if the company they worked for allowed it. Some companies, who were downsizing, would not permit retirement-age employees to remain on the job. Many retirees (who thought they were past the age of working) began looking for jobs as well. In a shrinking job market there are not many choices.

Most people dream of inheriting wealth or winning the lottery, even though they realize it is not likely to happen. Whether it is a state lottery, a weekend in Reno, or pork bellies we hope our lucky day will come. Unfortunately, when retirement is treated the same – just hoping for good luck – the reality is likely to be poverty. These individuals have not saved for retirement, have not set up any financial goals for retirement, and are not at all prepared financially for retirement.

Tough Economic Times

Retirement can be difficult in the best of times, but when the economy is bad, it is even more difficult because there are likely to be fewer programs and fewer funds available for the low-income elderly. There are additional concerns that Americans will have to pay for the indiscriminate spending of our government through additional taxation at both the federal and state levels. Politicians tend to seek funding from those least likely to retaliate at the voting booths; businesses often are selected for higher taxation since voters view companies as having more than their fair share of income. Unfortunately that sometimes equates into fewer employment opportunities as businesses cope with higher taxation. It will also equate into higher goods and services to cover the company’s increased taxation levels. One way or another, every citizen is affected by a difficult economy.
Inflation and Retirement

Inflation affects every aspect of our lives and retirement is no exception. Inflation can devastate even a good retirement plan because it devalues the investment.

An individual who believes he or she needs $55,000 post-tax dollars per year to support their current lifestyle must factor in the variables of inflation over the 20 to 30 years they will live in retirement. Many people enter retirement hoping to live only on their interest earnings; they may not be able to do so over the duration of their retirement due to inflation.

Inflation Definitions

“Inflation is when you pay fifteen dollars for a ten-dollar haircut you used to get for five dollars when you had hair.”
-Sam Ewing

"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."
-Ronald Reagan

"Some idea of inflation comes from seeing a youngster get his first job at a salary you dreamed of at the culmination of your career."
-Bill Vaughn

"Inflation is taxation without legislation."
-Milton Friedman

"Bankers know that history is inflationary and that money is the last thing a wise man will hoard."
-William Durant

"Inflation is the crabgrass in your savings."
-Robert Orben

"Inflation is when sitting on your nest egg doesn’t give you anything to crow about."
-Unknown

While such quotations might make us laugh, there is little doubt that inflation has a profound impact on those living on fixed incomes.

The Fourth Edition of the American Heritage Dictionary defines inflation as, "A persistent increase in the level of consumer prices or a persistent decline in the
What exactly is inflation?

Simply stated, inflation makes goods and services more expensive and decreases the value of one’s money.

Economists use the term “inflation” to denote an ongoing rise in the general level of prices quoted in units of money. In simple terms, inflation means each dollar buys less than it did a year ago or even just a month ago. The magnitude of inflation (the inflation rate) is usually reported as the annualized percentage growth of some broad index of money prices. Inflation is the ongoing decline of the overall purchasing power of our money. Not all countries experience inflation at the same time since it generally has to do with internal factors rather than global conditions.

Inflation is typically a problem to some degree in every country. Inflation rates vary from year to year and from currency to currency. Since 1950, the U.S. dollar inflation rate, as measured by the December-to-December change in the U.S. Consumer Price Index (CPI), has ranged from a low of -0.7 percent (1954) to a high of 13.3 percent (1979). Since 1991, the rate has stayed between 1.6 percent and 3.3 percent per year. Since 1950 at least eighteen countries have experienced times of hyperinflation, which means the CPI inflation rate has soared above 50 percent per month. Japan recently experienced negative inflation, or deflation, of around 1 percent per year, as measured by the Japanese CPI. Central banks in most countries today profess concern with keeping inflation low but positive. Some specify a target range for the inflation rate, typically 1–3 percent.

We often hear that we must return to the gold standard although it is most unlikely that we will actually do so. The gold standard meant America had quantities of gold to back up our paper dollar. Although economies based on silver and gold standards could experience inflation it seldom exceeded 2 percent per year, and the overall experience over the centuries was inflation of close to zero.

Today no country’s economy is based on the gold standard; all have gone to paper money. Economies on paper-money standards experience much more inflation than what occurred under the gold standard. The United States ended its last commitment to a gold standard in 1971. Our government cut the U.S. dollar’s last link to gold, which meant it ended its commitment to redeem dollars for gold at a fixed rate for foreign central banks. Even among countries that have avoided hyperinflation, inflation rates have generally been higher in the period after 1971. Even so inflation rates in most countries have been lower since 1985 than they were in 1971 to 1985.
Wages generally go up as the costs of goods and services go up, keeping a balance between the two to some degree. Earnings that keep pace with inflation prevent inflation from becoming a big concern for our citizens. However, when a retiree is living on their retirement savings inflation literally robs them of income.

Most investors underestimate the impact inflation will have on their retirement plans. Even at relatively low rates, inflation is a real thief of buying power over time. While there are varying opinions, most professionals calculate retirement needs using a three percent inflation rate, although there have been times in our history when it was as high as 10 percent.

Inflation is an investor’s biggest retirement worry. Sums that seemed adequate twenty years before retirement become dwarfed when inflation steps in, stealing the value of their lifetime savings. Inflation is one of the reasons annuities are often favored in retirement, utilizing a lifetime income option once the vehicle is annuitized.

Inflation works exactly like interest earnings – only in reverse. Instead of adding to the principal sum, it takes away from it leaving the investor with less than he or she originally accumulated and certainly less than they think they had.

In 2009, the U.S. posted a current account deficit of more the $1-trillion. In order to finance a deficit of this magnitude more than ten billion dollars every working day must flow into the United States. There was a time when America was a manufacturing country but unfortunately we are becoming a “service” country, moving our plants and manufacturing to countries with a cheaper labor force. Our jobs are increasingly moving to lower paying service jobs (the restaurant industry, for example).

While a "stimulus package" may put a few dollars into the economy, it cannot create jobs, which is what the United States needs. The U.S. must currently attempt to attract enough foreign capital to sustain a $1-trillion trade deficit, a $1-trillion current account deficit, net foreign debt of $15-trillion, and unfunded federal mandates of $54-trillion.

The United States is no longer a country that exports goods; in fact we are at the bottom of the list of exporting countries. Our citizens consume more than they produce. It is no coincidence that the three countries at the top of the list – China, Germany and Japan – have made significant structural reforms to their economies to an export-based model. We literally ship billions out in national wealth every year for non-durable goods.

Ten years or so ago Germany faced a similar situation. It was not easy but they transformed their country into an export-based model. France, Italy, Spain and Iceland took the path most countries take and borrowed their way to prosperity while money was cheap and easy. Now that the world is experiencing financial difficulties, these countries are buried in debt and asset deflation – and Germany alone stands as the major European representative on the plus side.
As individuals we probably feel incapable of changing what is going on financially in our country, but what we can do is protect ourselves and our future by putting dollars aside in some manner. Of course, in this tough economic time even that seems risky; maybe it would be wiser to hide our money in the mattress!

**Measuring Inflation**

The Inflation data (see table below) is calculated to two decimal places while the government only calculates to one. Even so, it is based on the government's index – just carried out to a more exact figure.

The inflation rate is calculated using the current **Consumer Price Index (CPI)** published monthly by the Bureau of Labor Statistics. At the time of this printing, there were no figures available beyond 2008.

<table>
<thead>
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<th>Year</th>
<th>Jan</th>
<th>Feb</th>
<th>Mar</th>
<th>Apr</th>
<th>May</th>
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In the United States inflation rates are usually measured by the percentage rise in the Consumer Price Index, which is reported monthly by the Bureau of Labor Statistics (BLS). A CPI of 120 in the current period means that it now takes $120 to purchase a representative basket of goods that $100 once purchased. Not everyone buys the same goods and services, however, so the figures represent a “general” index that may not be specific to every citizen. It is, therefore, a rough approximation of the percentage rise in your cost of living. This would be true for any alternative measure of inflation, such as the gross domestic product deflator, since each person’s use of services and products varies. The GDP deflator is probably more representative of the economy as a whole, but is less relevant to ordinary consumers since it includes the prices of non-consumer goods (such as new business equipment) that consumers do not buy, and excludes the prices of the many foreign-produced goods that consumers do buy.
Causes of Inflation

Simply stated, inflation occurs (meaning the dollar buys less goods and services) to the extent that the nominal supply of dollars grows faster than the real demand to hold dollars. A standard approach to analyzing the connection between the money supply (M) and the general price level (P) is an accounting equation called “the equation of exchange” of $MV = Py$, where $V$ denotes the number of times per year the average dollar turns over in transactions for final goods and services, and $y$ denotes the economy’s real income (usually measured by the real GDP). Since $V$ is defined as $Py/M$, the ratio of nominal income to money balances, the equation follows. The quantity theory of money states that a higher or lower level of $M$ (money) does not result in any permanent change in $y$ or desired $V$; in other words, it does not permanently affect the real demand to hold money rather than spend it. Most people would agree that a larger $M$ means a proportionally higher $P$. In simple terms, putting more dollars in circulation dilutes the purchasing power of each available dollar because the quantity of dollars has increased (based on the principles of supply and demand); prices rise when there are more dollars available to buy the same amount of goods.

Consumers often have difficulty understanding why printing more money would cause inflation. To achieve understanding, consider an economy in which all prices are balanced. Now imagine that the numbers on all money are magically doubled; at the same time all bank account balances are also suddenly doubled. Those selling goods and services would then also double their prices to keep up with the availability of money (items are typically priced according to the market indicators, in this case a doubling of the money supply). Price tags must be simultaneously doubled to keep the economy in equilibrium (balanced).

Another example: Fred T. Ford wants to sell his antique car. He initially thought he wanted to sell the car for $10,000 but Dale Doubling arrives with $20,000 because all the numbers on his money were doubled. Why would Fred still take only $10,000 for his car when $20,000 is now available? When the money supply doubled, the price did too.

We know that the numbers on our money are not going to magically double, but if the buying power of each dollar falls, instead of requiring one dollar to buy bread it may take two dollars (a doubling in the amount required). In effect, the numbers on the money doubled because the cost of the bread required two rather than one dollar to purchase it. That, my friend, is inflation.

The actual process by which the federal government injects new money (typically by purchasing bonds in the open market with newly created federal liabilities) differs from our examples since they obviously do not double the numbers on our money or in our account balances at the bank. One major difference: the initial spending of newly created money is on bonds, not on the consumer goods Americans would be buying. Following the sale of the bonds, the bond sellers’ banks, into which the federal government has
wired newly created reserves, will themselves buy additional securities (or make additional loans), expanding the banking system’s deposits as they do so. The actions of the federal government (and the subsequent actions of the commercial banks) expand the supply of money available for loans and therefore may lower the real interest rate. The commercial banks’ borrowers (predominantly business firms) may, at least temporarily, raise the relative prices of the assets they buy (business plants and equipment). Many economists assume that such relative-price effects are negligible, but others assign them a key role in their theories of the business cycle. If a company or manufacturing firm finds they owe more due to business loans, it is reasonable that they would then charge more for the products they sell to cover the higher cost of doing business. If the products we buy cost more (but we don’t simultaneously earn more) then our dollars are buying less and that, my friend, is again called inflation.

In short:

1. The government buys bonds in the open market;
2. The federal government creates money by wiring funds to the banks selling the bonds they bought;
3. The banks that sold the bonds will buy additional securities or make additional loans to businesses;
4. If a business borrows money, it must recoup the cost; sometimes that means raising the prices on the goods or services they sell.
5. Our dollars no longer buy as much, at least not from the company that raised their prices (which is why rising costs of goods may not affect every consumer equally – only those that want the goods this company sells are affected).

Americans are dedicated consumers since they typically consume more than they produce. A consumer is a buyer of goods and services. Americans have long been the global consumers, buying much more than most other countries, most of it on credit. If an American is a “saver” by nature and does not buy many goods or services, he or she is less affected by rising prices (inflation) than the individual who buys needlessly or has high credit card debt, since the cost of the interest charged on the credit card will erode the consumer’s buying power. The very poor are nearly always affected by rising costs and eroding dollar values because they do not have extra dollars to save; their money is spent on necessities, such as heat for their homes and food for their children. When their dollars buy less, it means turning off the furnace or going without higher priced food items, such as fruit and meats.

Money itself is neutral; money is merely a symbol of value. Once the gold standard was eliminated, money became a tool for trade. The actual dollar itself is worth only the few pennies it took to manufacture it. The dollar’s value comes from the words printed on it.
by the federal government: “This note is legal tender for all debts, public and private.”
If our government did not exist, paper money’s value would not exist either.

Many people have traditionally believed the ups and downs of our economy are natural and generally not harmful since everything tends to rise in proportion, including wages. In fact, wages have not risen at the same pace as prices over the last twenty years. The standard of living for the middle and lower classes have fallen in America rather than kept pace with rising prices. We also want more sooner, which is why some of the economy’s measurements are hard to compare to standards that existed fifty years ago. Our grandparents did not expect two cars in the garage; technology was much different fifty years ago, with no demand for computers, cell phones, and big screen televisions. Our grandparents were more likely to be savers (rather than consumers). Most children did not have to keep up with their classmate’s clothing standards in order to be accepted; there were no competitions for the newest technologies. In many ways, we have created our financial nightmare and it is we who must find the solutions if we wish to return to the financial comfort America once knew.

In the long run, it is reasonable to assume that rising prices largely wash out with rising wages, although some Americans will be more severely affected than others depending on the job industry that employs them. When the economy begins to also affect employers, however, it is very difficult to gauge the long-term effects. An unemployed person does not spend; if enough people do not spend, business and manufacturing is affected, causing additional loss of jobs and a downward spiral of the economy. At some point it will level off, with goods and services costing less than before and eventually (or so the theory goes) bringing back balance between money and pricing.

Most professionals feel a achieving zero to low inflation generally requires the central bank, which controls the money supply, to refrain from expanding the money supply too rapidly. The Federal Reserve System could theoretically maintain zero inflation by appropriately controlling growth in the stock of American dollars. In recent years central banks elsewhere in the world (Australia, Canada, the euro zone, New Zealand, Sweden, and the United Kingdom) have announced a target range for their inflation rate, generally 1 to 3 percent. For the most part, they have been successful. Current times may stress their past success, however.

Consequences of Inflation

Inflation can be harmful; that comes as no surprise to any adult who has seen the changes brought by inflation. If the actual inflation rate is anticipated the economy generally has the ability to deal with it effectively (interest rates go up and down in relation to inflation, for example). The harm is greater if the actual inflation rate is not that which was anticipated because then corrective measures come after the event rather than before or simultaneously with it.
Although lenders and borrowers generally do not suffer from a higher inflation rate when the rate is well anticipated, holders of non-interest-bearing forms of money, such as currency, do (the dollars stuffed in the mattress go up and down with the inflation rate). Inflation has the same effect on currency as would higher taxation, since buying power is eroded with no interest earnings to offset the erosion. Inflation drives investors into sometimes costly strategies in an effort to avoid holding actual currency.

In addition to the tax-like effect on cash balances, at least one other harm stems from higher inflation even when perfectly anticipated. With higher inflation, published prices become obsolete more quickly, and so price setters must more frequently incur the costs of adjusting nominal prices in brochures, catalogs, restaurant menus, and so forth. Economists sometimes call these “menu costs” since they include reprinting restaurant menus as well as changing price tags on supermarket shelves, revising catalogs, replacing numbers on gas station price signs, and so on.

Low inflation is clearly preferable to high inflation but ordinary citizens typically feel powerless to correct such issues. Additionally, what is the optimal inflation rate? Few of us would have any idea, although “zero” sounds pretty good to most of us. Economists often state around 3 percent as a desirable inflation rate.

While it is definitely necessary to save for our future, it is also necessary, from society’s point of view, to spend. President Obama was asked why the United States was proposing a stimulus package to encourage American spending while many economists were stressing America’s inclination to overspend, rather than save. Wasn’t that encouraging the very actions that got America into her crisis? While many feel the financial crisis emerged from the mortgage sector (giving loans to people who could not afford them and often could not repay the loans) our lack of saving is certainly an element of the financial crisis. Naturally occurring inflation seldom entered into the discussion as a reason for our recent financial depression.

Where the tax code is not fully indexed, higher inflation increases the distorting effects of taxes. Before the U.S. income tax brackets were indexed, inflation pushed income earners with unchanged real income into brackets where they faced higher marginal income tax rates. This discouraged people from making taxable income. With indexing of federal tax brackets in 1985, this distortion disappeared. However, the capital gains tax is still levied on nominal gains, not on real gains (inflation-adjusted gains). It is important to realize that an asset with interest earnings the same or below inflation rates has not grown; in fact it loses value once taxation is applied (one reason annuities and other tax-deferred vehicles are favored in high inflation periods). The asset’s gain is not adjusted for loss to inflation; it is taxed along with any real profit. The higher the inflation rate, the higher the effective tax rate on the real capital gains, even with an unchanged nominal capital gains tax rate. Higher inflation discourages capital formation by discouraging people from accumulating taxable assets that will be penalized by inflation.
Unanticipated Inflation

When inflation rates are *incorrectly* anticipated, financial trades are upset. If inflation is *higher* than expected, the borrower must repay loans in less valuable dollars, at the expense of the lender who gets less back in purchasing power. If the inflation rate turns out to be *lower* than anticipated, the lender gains at the expense of the borrower (assuming the borrower is able to make the greater real payment). For example, the federal government, because it is the U.S. economy’s biggest debtor, gains from unanticipated inflation and loses when inflation is less than anticipated. As a result, the federal government is biased toward higher inflation.

One of the reasons money becomes tighter when future inflation rates are uncertain has to do with whether the lender feels it will gain or lose in dollar-repayment values. Uncertain future inflation rates translate into uncertainty for new loans, since the lender cannot be sure repayment dollars will be less or more than current values. It also might mean risk-averse parties shy away from making debt contracts (deposits, loans, bonds). Because inflation becomes more variable as the average inflation rate rises, high-inflation economies have stunted banking and bond markets. The real returns from holding bonds and loans of long maturities on such things as thirty-year corporate bonds or thirty-year fixed-rate mortgages are especially sensitive to inflation variability. That is one reason mortgage loans with ten to fifteen year pay-off dates (maturities) have lower interest rates than thirty year contracts. It is easier for the lender to make inflation estimations on shorter term loans. When an economy moves to higher or more variable inflation risks some long-term contracts might be unobtainable for the majority of borrowers. Long-term investments are discouraged due to the greater risk in financing them.

High-inflation currencies can stunt stock markets, although the reason for this is not universally agreed on. One possible reason is that higher inflation is associated with less uniformity in price changes. This is sometimes referred to as inflation “noise.” It is the constant change in pricing without uniformity. In other words, some markets begin to experience constant price increases while others seem unaffected or moderately affected; prices may also be changing at different speeds with all going up but not uniformly. As a result, investors are not able to put as much credence in the earnings reports of companies listed on the stock exchange. High profits for a firm may only be temporary having more to do with luck than company stability or profits. In such an economy, established savers often shy away from stock markets, along with other higher risk vehicles. They may save less or they may save in different ways, utilizing financial vehicles with greater guarantees. Again, annuities often benefit during such times as the savers divert their dollars to inflation hedges. In the past many of these investors also invested in real estate, gold and other precious metals.

Another possible reason why inflation reduces the value of corporate shares is that the corporate income tax system in many countries is not fully indexed. Firms face higher
real tax burdens as inflation rises. Any additional taxation passed during difficult times is also likely to be levied against businesses since the federal government traditionally feels they are better able to absorb additional overhead than poor or middle class America. What is often not realized is that the businesses often affected by higher taxes are the smaller companies employing fewer than 100 people (the “low income to middle class” of business entities).

The so-called “noise” generated by high inflation can also affect us in ways we do not realize. The constant changing of prices (or “noise”) brings about poor communication of actual facts. It might relate to misinformation (which distorts investment and employment decisions), lack of information, or distorted information. Additionally, in such times investors often do not trust the information they receive, even if it is currently accurate. Inflation takes even good information and changes the facts over a short period of time. For example, XYZ Company reports a good third quarter income. Even though the facts reported are accurate, investors know that the quarterly figures can be very different in the next reporting since high inflation often means consumers spend less. XYZ Company could experience reduced consumer spending in a very short period of time.

So, does inflation have any benefits? Some Keynesian macroeconomists once believed that higher inflation could “buy” a permanent reduction in our employment rate. Economists now agree that no such exploitable trade-off exists; it seemed to exist in the 1960s only when higher inflation was a surprise. A surprise rise in inflation can reduce layoffs (by making dollar sales unexpectedly high) and shorten job search (by making dollar wage offers unexpectedly high), and lowering the unemployment rate below its natural level. When workers come to expect a high inflation rate, as they did in the 1970s, unemployment returns to its “natural rate.” Using the same logic, a surprise reduction in inflation can raise unemployment above its natural rate, creating additional problems.

Although everyone agrees that high inflation is not desired, opinions vary over whether an inflation rate of zero percent is better than a rate of 3 percent. There are two main cases in favor of a positive inflation rate. Some argue that zero inflation would lead to inefficiency if wages and prices became stagnant. In their view, a little bit of inflation provides “grease” to the economic system. Others believe a positive inflation preserves the Federal government’s ability to cut rates if looser monetary policy is needed.1

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1 Lawrence H. White is the F. A. Hayek Professor of Economic History at the University of Missouri, St. Louis.
Do the Math

Failure to account for inflation when calculating retirement needs is a huge mistake that is only realized when it is too late to correct the miscalculation. The real world implications of inflation can be seen by the following: assume that you now require $35,000 a year to maintain your lifestyle and would like to maintain that standard of living in your retirement. A three percent inflation rate is used - the historic average (neither low nor high):

- Based on the $35,000 per year currently required, you would need $47,037 each year in 10 years to support the same standard of living.
- $63,214 per year would be required in 20 years (age 85 if retired at 65).
- If you retire at age 65 and live to be 99 years old (another 34 years), you will need $95,617 per year to maintain the same standard of living that $35,000 per year initially provided.

Adjusting the inflation rate upward just one point to four percent then changes the $63,214 required for 20 years of support (until age 85) up to $76,689 or an additional $13,475 per year. The math is even more staggering for an individual that is currently living on $60,000 per year and wishes to continue that lifestyle. At just a three percent inflation rate the retiree will need the following amounts to support the same expenses:

- $80,635 per year in 10 years.
- $120,000 per year in 20 years.
- $163,914 in 34 years (If you retire at 65 and live to 99, you have lived 34 years in retirement.)

Obviously everyone should adequately plan for their retirement and it seems ridiculous to have to state that. The sad news, however, is that far too few people make any plans at all for retirement, apparently assuming that their lives will somehow be taken care of by the government, their children, or simple luck. We Americans are an optimistic bunch of people.

Retirees will have Social Security and perhaps a pension to live on in retirement and help compensate for inflation but if the retiree has not also personally saved, it may not be adequate. Those that are living in retirement by withdrawing from principal as well as interest earnings will require far more money to support their lifestyle throughout retirement than those that have adequately planned. Inflation harms all investors, but especially those that are dependent upon the principal as well as interest earnings.
Insufficient Planning

Insufficient retirement planning is common in America. While some planning is better than none at all, there are three mistakes commonly made:

- Not saving enough for retirement;
- Not guaranteeing enough income for retirement, requiring the retiree to drain their principal as well as interest; and
- Not protecting their retirement assets from market harm.

Not guaranteeing one’s retirement income or effectively protecting retirement assets is a serious problem, but they are only problems if the investor actually has achieved some savings. Those who failed to save anything obviously have nothing to protect and poverty is already in their future.

Although many people may believe they have adequate resources for retirement, few actually do. That toy or stamp collection is not likely to bring in the fortunes that were dreamed about.

A report from the Employee Benefit Research Institute (ERBI) found that 45 percent of all U.S. households have less than $25,000 in assets excluding their home, yet two-thirds of all workers said they expect to live as comfortably in retirement as they did when they worked. The average person will spend that $25,000 in two or three years – even with their Social Security benefits. Let’s face it: $25,000 is not much money considering what it takes per year to live.

According to the ERBI report:

- Ten percent of workers believed they would need less than 50 percent of their current income to live comfortably even though they expect to keep the same standard of living.
- Twenty-eight percent believed they would need 50 to 70 percent of their income to live comfortably.

Both groups are wrong. Most financial experts agree that individuals will need between 70 to 80 percent of their employment income to live comfortably, not counting inflation. Therefore, if the individual currently earns $50,000 per year and expects to live in retirement for 15 years, depending on how assets are held and how inflation performs, well over $500,000 in interest producing retirement assets will be required. That figure could be much higher depending on health care requirements. Long-term care needs, such as nursing home care, are among the most costly retirement expenses. Few people currently plan for these additional costs since they are not experienced during their
working years and it is often just current costs (utilities, food, and so forth) that are used to determine retirement needs.

**Longevity**

The biggest fear in retirement is having more life than money; living longer than the assets do. When planning for retirement everyone wants to insure that they have enough money to cover living expenses for every day they live. The difficulty lies in knowing how long one will actually live. Therefore, it is always best to save more than necessary versus less than necessary.

According to the U.S. Census Bureau, in 1900 only 3.1 million people were aged 65 and older. Today, that number is more than 35 million. The average life expectancy in the U.S. is more than 77 years; that figure is expected to be 85 by the year 2065 according to Ronald Lee, an economic demographer at the University of California, in Berkeley.

*Life expectancy figures are misleading, however.* If it seems to you that we have many people over age 80, you are right. Life expectancy figures are averaged for *all deaths* regardless of age, so they include infant and other young person deaths making the average “life age” deceivingly young. When young deaths are eliminated from the studies, we show a much longer life expectancy.

In 2001, studies showed:

- Life expectancy for people reaching age 65 was 83 years old.
- For those lucky enough to reach age 75, life expectancy grew to age 86.5, a whole decade higher that the generally stated life expectancy of 77.
- According to the New England Centurion Study, people ages 100 and older are the fastest-growing segment of the United States population, and this pattern is expected to continue.
- There is a 50 percent chance that at least one partner from a couple in their 60s will live to the age of 95.

If we view our retirement based on the previous statistics it means we need to plan for a longer life than we often do, which means more assets are necessary than we might initially believe. *We have a good chance of living to age 85 or longer.* Good health and good genes contribute to a long life so we may be able to judge some of this by our relatives but our lifestyle also plays a role. Most people are born with a set of genes that would allow them to live to age 85; it is lifestyle that reduces those odds. Those who take good care of themselves may add as many as 10 quality years, living to age 95. Individuals who smoke, are overweight or fail to practice preventive medicine may subtract substantial years from their lives. New studies tell us that remaining active and
socially involved is important to maintain not only physical health, but mental health as well.

For many retirees, retirement represents a step down in their quality of life, with less travel opportunities and vacations, less ability to buy unnecessary luxuries, and sometimes even less ability to purchase necessary items, such as home repairs. Especially when health problems exist that require frequent out-of-pocket expenses or when necessary dental care takes up extra savings retirees will find they no longer have extra funds for the pleasurable activities they once participated in.

Particularly threatening to the retiree’s savings will be long-term care requirements, such as a nursing home admission. Nearly two-thirds of U.S. households (64 percent) won’t be able to maintain their standard of living in retirement because of the cost of long-term care. Some of these individuals will have a nursing home policy that is inadequate, so while some benefits are perhaps better than none, it does not mean freedom from potential long-term care expenses, according to a study conducted by the Center for Retirement Research at Boston College.

It is common to hear retirees refer to their homes as their future retirement fund. However, even tapping into home equity doesn’t necessarily help. Researchers found that 65 percent of households using a reverse mortgage to pay for long-term care costs were still not living as well in retirement as they did while employed.

Not everyone will require long-term care, of course. Even without these costs, most retirees retire to a lower standard of living. Research indicates that 44 percent of households without current long-term care requirements still have a lower standard of living in retirement. Unfortunately few people entering retirement consider the costs that will remain or even rise with time, such as dental care (which is not covered by Medicare or Medicare supplemental insurance), prescriptions, heating costs, gasoline, and other routine expenses that continue to go up over time. For many retirees, their rising costs of living are not offset by rising income.

Experts expect this situation to get worse, not better. Households unable to maintain their standard of living in retirement will increase dramatically with each subsequent generation due to less savings and greater expectancy for help from the government. Research indicates that 52 percent of boomers born between 1948 and 1954 are at risk of being financially unprepared for retirement, compared with 64 percent of those born between 1955 and 1964, and 71 percent of those born between 1965 and 1974. Americans seem to be consistently saving less rather than more for retirement. We also seem to be spending more, acquiring greater debt even into retirement, which increases the difficulty of meeting daily needs in retirement.

A survey conducted in 2009 by the nonprofit Employee Benefit Research Institute found only 13 percent of adults said they were very confident that they’ll be able to afford a
comfortable lifestyle during their retirement years. That’s down from 18 percent in 2008 and 27 percent in 2007, according to the survey.

If current retirees realize they cannot afford to retire why haven’t more people put money aside for retirement? Only 20 percent told the institute they are very confident that they will have financial security throughout their remaining years, a decline from 29 percent in 2008 and 41 percent in 2007. One would think this would prompt people to better prepare themselves, but that has not been the case. Workers mostly cited economic uncertainty, inflation and the cost of living as reasons for losing confidence about retiring comfortably. They do not seem to focus on lack of personal planning, although many did cite the loss of retirement account values as a major reason for their concern. Twenty-eight percent said they plan to retire later to increase their retirement security. Additionally, 72 percent said they expected to supplement their income by working during retirement.

Retiring Too Soon

In the past it was common to see workers expressing the desire to retire in their fifties or even forties. In today’s economic times workers will find that more difficult to do. Our life spans are increasing dramatically and this requires greater assets for retirement. We may still wish to retire earlier than our sixties but the likelihood of accomplishing that is becoming more difficult.

A hundred years ago, most people worked until the end of their lives. Until recently only 16 percent of men in the U.S. worked past their 65th birthday, but that seems to be changing, as people reassess their ability to retire.

What prompted our workers to begin retiring at age 65? While there are no firm studies to tell us, two theories seem probable:

Social Security began: the rules governing Social Security were written in the 1930s. Program guidelines favor retirement around the age of 65 with a higher rate of taxation on wages earned at older ages. Social Security payments can start as early as age 62, but full retirement age was originally 65. Today, many people do not receive full Social Security retirement benefits until age 67.

Rising Income: the other theory says Americans began to retire rather than continuing to work because leisure activities became valued more than work. As Americans earned more money, often due to two working adults instead of one, workers could afford leisure activities. It was simply more enjoyable to do what was fun instead of work.

The point is not whether one is better than the other (leisure versus work), but rather a discussion of funding those leisure years in retirement. Few individuals save adequately
for emergencies; they certainly don’t save adequately for retirement. While Americans earned more, they still failed to save adequately, perhaps because Social Security was created. While we now realize that it would be difficult to live solely on Social Security, we still do not save as we should for our retirement years.

The majority of Americans start collecting Social Security at the age of 62. This leaves many years of life to fund if they are no longer working, and it also reduces the amount of money received each month from the government.

As workers approach the age of 62, he or she must decide when to begin taking Social Security benefits. An individual can begin as early as age 62 or wait until full retirement age, which is between the ages of 65 and 67, depending on when the worker was born. He or she could also delay benefits until age 70.

The earlier Social Security benefits begin, the less received each month since the government will be funding the worker for more years. If the worker begins to collect benefits, but continues to work, benefits may be reduced even more.

Up to 85% of Social Security benefits are taxed. If the worker is forced into retirement by his or her employer, Social Security benefits may be needed to cover his or her living expenses. In such a case, there may be no choice as to when to begin collecting Social Security. If the worker does not immediately need the income from Social Security then the choice is more complex.

Even gender and marital status makes a difference when deciding when to apply for Social Security benefits.

- **Single women** usually benefit by waiting as long as they can to begin collecting benefits. Since women usually live longer than men they need the higher payments that result from waiting until full Social Security benefits are available.

- **Single men** have a greater chance of dying sooner than some other groups, such as women. Therefore, they have a more complicated choice, but if family medical history points to a shorter life expectancy it may be best to begin at age 62.

- **Married couples in which the wife has low or no wages** tend to do better to claim benefits for the wife as early as possible (waiting will not greatly increase her SS income) but delay benefits as long as possible for the working husband.

Early benefits from the wife allow the couple to collect for an extended period of time, while preserving the couple's maximum benefit for the wife. A wife who survives her husband is eligible for 100% of his benefit.

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2 SSA.gov
According to research done by the Center for Retirement Research at Boston College, the best formula for the average household was for the wife to claim at age 62 and the husband to claim at age 66.

- **Married couples in which the wife's wages were closer to the wages of the husband** still do better if the wife claims early and the husband delays benefits to age 69.

## Retirement Funding

Certainly no one expects to live in poverty once they retire; it just happens due to lack of planning. The ideal retirement occurs when you have:

1. **Guaranteed Income:** Every retiree needs enough guaranteed income to cover their living expenses in retirement. The goal is to have enough income to continue the lifestyle that was enjoyed prior to retirement. What do we mean by *guaranteed income*? Income that is not dependent upon the stock market or other variables. Guaranteed income would include Social Security benefits, employer-sponsored pensions, fixed annuities, and perhaps even a reverse mortgage.

2. **Additional Retirement Assets:** While all retirees need income they can depend upon (guaranteed) that doesn’t mean individuals should not also have assets that are variable, such as 401k plans, IRAs, variable annuities, stocks, or other types of assets to cover additional or unexpected expenses. It is always better to have too many assets than not enough. Every retiree must be ready to fund their retirement for many years or live in poverty at the end of their lives if they under-funded their retirement.

3. **Adequate Insurance:** Agents certainly love it when economists, financial planners, or television personalities suggest the purchase of insurance. When it comes to retirement, however, the importance of insurance cannot be overlooked. It is during this time of life that very costly medical needs are most likely to develop, such as long-term debilitating illnesses or even simple frailty related to aging. Retirees should plan for the purchase of long-term care insurance (such as that used to fund nursing home care) as well as good major medical coverage of some type. States now have the legal ability to enact Partnership long-term care legislation thanks to the Deficit Reduction Act of 2005. Prior to this legislation only four states had these asset-protecting long-term care policies available. Even if the retiree lived in one of the asset protecting states, he or she could only be assured of this protection if they remained in that state during retirement. Today, thanks to the DRA legislation, these policies are fast becoming available in all states and in many cases, the retirees can carry the asset protection with them if they move to another state.
Rising Medical Costs

It is surprising how many retiring individuals do not consider the higher costs of medical care in retirement. Out-of-pocket medical spending can ruin finances very quickly at any time, but especially in retirement since there won’t be any way to earn extra money. While most retirees realize that Medicare will not pay for all their doctor and hospitalization bills, too often the costs of long-term care are overlooked. While we most often associate long-term care with nursing home costs, this is not always the case. It could also be extended costs for care at home or in the community.

Many retirees are not prepared for the high cost of medical care in retirement after their company-sponsored plan is no longer available. As we know, Medicare covers many of the expenses connected to hospital and physician care, though not all costs. There are deductibles and co-payments if another supplemental insurance is not purchased. While this may seem obvious, those with few assets may have difficulty covering the co-payments and deductible amounts, as well as items not covered at all by Medicare, such as dental. This is especially difficult for retirees with little or no assets. The fewer assets available, the faster they will be used to cover medical care, leaving even less money available for basic needs.

Beneficiaries with incomes below 135 percent of poverty spent an average of 33 percent of their income on health care. Beneficiaries with incomes above 400 percent of poverty spent 12 percent of their income on health care.3

Medical costs may be higher in retirement for several reasons:

- More services are typically required as one ages;
- Insurance premiums may be high for some types of coverage, such as nursing home care insurance; and
- The cost of medical services have been dramatically rising in recent years, increasing every year far beyond the pace of inflation.

The cost of medical care has outpaced inflation for the past 20 years. Industry experts expect these increases to continue. Some industry surveys predict that costs will rise as much as 15 percent each year, which affects everyone, but especially those on fixed incomes and those who need care more frequently. Increased medical costs are likely to double the cost of retiree health care in just five years.

Health care spending (as a share of after-tax income) will probably continue to rise dramatically. In 2000, health care spending for older married couples was 16 percent of

3 GOA report, 2007
their total income. According to figures provided by the Center for Retirement Research, that number is expected to increase to:

- 24 percent of income by 2010;
- 29 percent by 2020; and
- 35 percent in 2030.

As the baby-boom generation enters retirement with too few dollars saved, they are likely to be financially devastated by the health care costs they will eventually face as they age. Additionally, our knowledge is advancing providing additional types of care for many ailments of aging than ever before. If the retiree is requiring more health care services, obviously someone must pay for the care received. Healthcare costs are increasing because of:

1. Advances in medical technology providing better, but more expensive treatments.
2. Increased incidence of expensive-to-treat medical conditions.
3. High administrative costs associated with a fragmented health care delivery and financing system.
4. The existence of many highly paid medical specialists who treat ailments that were often ignored in the past.

We cannot blame the patients who seek the care, nor the professionals providing the care. We all expect the best medical care available whatever our age. The medical profession is continually advancing in their knowledge and treatments. Medical care developments promise remarkably long and healthy lives, but these advances can also be costly both in the research involved and the discoveries made. Often they promote longer lives, but those additional years may be frail years, requiring nursing home care due not to disease or illness, but simply from becoming frail and helpless.

We know that getting older means increased health care costs; even such things as reading glasses, hearing aids and dental work increases with age. In these tough economic times it is difficult to fund the increasing costs of Medicare and Medicaid. Both the federal and various state governments are having difficulty funding all the programs desired by our citizens. We do not currently meet the medical needs of our poor and disadvantaged children, yet the nation’s elderly will receive the majority of our health care funding (and even they will not be fully cared for).

Social Security is already overtaxed by large numbers of people entering retirement and our increasing longevity. Policymakers are concerned it will be difficult funding the needs of the retiring baby-boom generation, possibly creating severe shortages in Medicare and Medicaid funding. This is being addressed to some degree by encouraging those entering Medicare to select managed care organizations for their medical coverage.
Medicare trustees predict program costs will grow rapidly over the next 75 years. In 2000, Medicare consumed 2 percent of the Gross Domestic Product (GDP) in the United States. By 2030, Medicare will reach 7 percent of the nation's GDP, and 14 percent by 2080. This may seem like a small percentage, but it is actually a staggering percentage of the nation's budget and is probably unsustainable, especially as our workforce dwindles in comparison to the percentage of those in retirement.

We do not know how the United States government will fund these programs in the years to come, but it is very likely that benefits will be lowered. The overall structure of medicine might even change dramatically in an attempt to solve the rising health care costs associated with growing older.

It is not just our government that is wrestling with the growing costs of health care in the United States. Companies must also figure out how to fund private insurance for their workers and retirees. Many companies are simply discontinuing medical coverage for retired workers, stating the costs are overwhelming and detrimental to the survival of the business.

Such developments are making it more important than ever for employees to familiarize themselves with what their employers offer and to evaluate how health care costs will impact their retirement. Many considering retirement do not realize the health care costs they will face. This is especially true of those planning to take an early retirement. Medical care will be expensive at any retirement age, but the costs can be far greater if retirement is taken prior to age 65 (when Medicare becomes effective) and there are no company-sponsored benefits for medical care in retirement from the employer.

The highest rates for individual health insurance are for those between the ages of 55 and 65 years old. Because of the high cost of medical coverage prior to Medicare eligibility, a typical worker retiring at age 62 that does not have any subsidized retiree-medical benefits would replace only 59 percent of his or her pre-retirement income, according to Hewitt Associates, a management-consulting firm. A couple retiring at age 60 requires in excess of $200,000 per year to cover medical expenses in retirement versus $160,000 if they retired at age 65. Certainly $160,000 is also high, which emphasizes the need to purchase medical coverage. Some people choose to gamble that their health will remain good, so do not purchase any health insurance coverage, but it only takes one major illness to turn that into a poor choice.

Retirement medical costs are likely to increase simply due to aging. Many financial advisors stress the following issues to their retired clients:

- The need for private medical insurance that works in cooperation with Medicare once the retiree is 65 years old; this might include an HMO, PPO, Medicare Advantage plan or the Original Medicare plan.
Catastrophic coverage prior to age 65; often these have large deductibles since the intent is to cover the medical crisis that would bankrupt the retiree or at least deplete their assets substantially.

The need to plan for long-term care needs, such as a nursing home or some type of community care that is on-going for a long period of time. Even if the retiree is currently healthy it may be wise to buy a nursing home policy since today’s health is not necessarily tomorrow’s.

A substantial amount of money that is set aside primarily for health related issues, whether that happens to be long-term care needs or even dental care over the length of the retirement (which is not covered by Medicare).

There are other issues that are relevant to retiring and are often discussed by financial planners prior to retirement. These include, but may not be limited to:

- The high rate at which medical costs are increasing (around 15 percent each year);
- Possible reductions in benefits from the government due to increased numbers of retired people collecting benefits;
- Possible reductions in benefits from company plans for retirees as cost-cutting measures become necessary to remain profitable;
- Prescription drug coverage; if the individual is Medicare eligible, this would include discussion of Part D services;
- Dental, hearing and vision expenses that are primarily paid for out-of-pocket; and
- The anticipated retirement date. The age at which one retires affects many issues, including the types and costs of insurance that should be considered.

**Long-Term Care Insurance Policies**

Statistically, many people over the age of 60 will need some form of long-term care prior to their death. The majority of these will require such care in the final years of their life, but many people do enter a nursing home, recuperate, and return home.

For some years there was much controversy as to whether or not an individual needed to consider purchasing nursing home benefits. Agents were often criticized for selling “unnecessary” coverage to their clients at high premium rates. As people aged, however, and the LTC policies paid benefits many of these attitudes changed. Those who advocated “saving cash to cover such expenses” have come to realize the error in this recommendation since few people will be able to save sufficiently for the high costs of nursing home care. There were even a few lawsuits filed over such faulty advice. This is not to say that every person needs to buy a long-term care policy, but such coverage
should be understood and each individual situation considered. For those with assets, such a purchase is likely to make financial sense.

Many people automatically assume we are talking about care in a nursing home when we use the term “long-term care insurance.” Actually, long-term care can happen anywhere and does not necessarily occur in a nursing home, although that may be the most costly location. Long-term care is a category of healthcare provided for people who are physically or mentally unable to provide independent care for themselves. Such care might include:

- Custodial care, which is non-medical care; this generally includes help with the activities of daily living, such as bathing, eating, dressing, continence, and other related activities. Even ambulation (the inability to move without assistance) may be a reason for receiving non-medical personal care.

- Intermediate nursing care for assistance with medications or other medical procedures on a part-time or intermittent basis.

- Skilled nursing care, which is medical care of some type. Most types of care, whether custodial, intermediate, or skilled will be performed under the guidance or supervision of a physician.

- Adult day-care where the individual sleeps at home but spends their days at a community location where supervision and activities are provided. There may also be some form of rehabilitation or medical care provided. Often the difference between the type of care received may be seen in the name of the care facility (adult day care or adult medical day care is often used to distinguish the difference in care levels).

- Any services needed by individuals with a disabling or chronic condition that impairs their ability to meet their own needs can be considered long-term care. Federal criteria for tax-qualified policies require that such care occur for no less than 90 days in order to be deemed “long-term.” Agents must check with their resident state to see if there are specifics relating to this in their own state statutes.

Of course, not every retiree will end up needing long-term care services beyond what their family members are able and willing to supply. When creating a retirement plan, it is very important to understand what care the family may be able and willing to supply and whether or not such care would be realistic. Medical professionals often say that the retiree’s family may be willing, but not truly understand the full implications of providing such care day-in-day-out around the clock. Therefore, some questions must be considered, including:

1. Since we know statistically that one in four people aged 65 and over will need long-term care at some point, does the retiree have family members who have needed such care? Family history is always an important consideration. If high blood pressure runs in the family, we always tell our doctor because we deem it
important. It is just as important to the retiree’s probable future if their parents both ended up needing long-term care, for example.

2. If the retiree reaches age 85, he or she has a one in two chance of needing long-term care services. Is there a family history of longevity?

3. Do some medical conditions run in the family, such as Alzheimer’s or even some types of arthritis? Maybe the retiree is already dealing with a physical condition that might warrant the purchase of a long-term care policy. Long-term care policies underwrite differently than other types of insurance, such as life insurance. The underwriters are less concerned with conditions that kill suddenly and more concerned with conditions that do not kill but continue for many years, such as some forms of severe arthritis that make taking care of oneself difficult. As with all types of insurance, the time to buy is before such medical conditions exist, although underwriters often consider family history to some degree.

4. What is the retiree’s preferred lifestyle? Does he or she stay active, maybe golf several times each week, or participate in physical activities such as aerobics, walking regularly, or other types of activities that help both physical and mental alertness?

People have always required increased care as they aged, but in the past it was handled by stay-at-home family members, so care was not so expensive. It is not actually the long-term care itself that is the problem. Rather it is the high costs of receiving long-term care that causes financial ruin. Long-term care services are not covered by Medicare, Medigap supplemental policies, or other private major medical insurance; only policies that are specifically written to pay for long-term care costs will cover the care. Many people will face a major healthcare crisis in retirement yet few people plan financially for it. The money spent on long-term care could significantly reduce or even wipe out a retiree’s savings.

Few people have amassed sufficient financial reserves to cover a long-term care medical need. The government will not pay these costs until the retiree first spends down all their own assets (unless a Partnership asset-protecting policy has been purchased).

Selecting the Appropriate Insurance Policy

Long-term care insurance could be considered a type of disability coverage as well as medical coverage. These types of plans have been around far longer than most people realize, first being offered in the mid-1980s. Initially long-term care insurance was primarily inadequate, often not covering such important areas as custodial or personal care. Today’s policies are obviously much better as state and federal requirements were passed and industry competition required better coverage.
Those considering the purchase of a long-term care policy must take some prudent steps to ensure the company will still be financially strong when benefits are requested. Many long-term care insurance buyers will not need to use their insurance until ten or twenty years after purchase. Only the highest rated companies should ever be considered. No agent should promote policies from companies that are anything less than top rated.

If the agent’s state offers Partnership long-term care policies, most professionals highly recommend they be sold, since they offer asset protection for the consumer. Although the Deficit Reduction Act of 2005 allows all states to offer this type of product, not all have passed the required legislation regarding Medicaid asset recovery requirements. If the agent’s state has passed such legislation, he or she must then acquire the education needed to sell such products. In some states, specific course outlines are used and the courses must be state approved. Most states use the NAIC course outline. If that is the case in your state, completing the Partnership long-term care course in your state will be sufficient for any other state you sell in; just show proof of completion. Not all states are reciprocal however, especially if the non-resident state has a state supplemental that must be completed. A state supplemental is a chapter of state-specific LTC requirements that is added to the Partnership long-term care continuing education course. In states that have specific long-term care course criteria, the state approved course would require a certificate be issued showing the credits and course number issued by the state insurance department. In states that do not have state requirements, a “training” requirement may still be required prior to selling or presenting Partnership long-term care policies to a consumer. A training requirement is not necessarily state approved, meaning the agent might not receive any state-approved education credits upon completion of the course. Most professionals will seek out a course that is state approved since he or she might just as well receive credits towards their license renewal upon completion of the education, even if it is just a training requirement rather than a CE requirement.

It is important that the long-term care coverage purchased, whether Partnership or traditional, be sufficient. While some coverage may be better than none at all, it is usually best to purchase adequate benefits. Not everything will be covered by even a good long-term care policy. Drugs, supplies and special services are not generally covered by long-term care insurance policies. Additionally, some plans are very specific in what they cover, such as care in the nursing home or care in one’s home. Partnership LTC plans will all have inflation protection included (it is a requirement of the policy) but non-tax qualified long-term care plans generally have it available only as an option (at extra cost). Since inflation protection is very expensive, many chose not to purchase it, but it is a valuable element since these policies may not be used for many years.

Long-term care insurance is expensive. The younger one buys it, the less expensive it is. So this is one case where it makes sense to purchase early. It is not unusual for a policy to cost between $3,000 and $4,000 per year, but just a few months of receiving benefits often returns all the premiums paid, with every month of benefits thereafter representing preserved assets because they will not be depleted to pay for care costs.
Preserving Retirement Plans

Many types of retirement funding are held in financial markets that are subject to highs and lows. When planning for retirement it is important to have at least some retirement assets in guaranteed markets, such as annuities, to maintain protection from swings in financial markets. Such things as a sluggish economy, natural disasters, terrorist attacks, corporate scandals and other unforeseen events affect the stock market and the retiree’s ability to fund their retirement.

Those nearing retirement must plan for specific income every year he or she lives. That is not always easy, since we don’t know how long we will live, but it is possible to plan for continual income from assets that will continue to pay for as long as the plan beneficiary lives. Most assets do not guarantee a rate of return forever, as a company-sponsored retirement plan might, so it is necessary to have adequate assets to survive even in a down economy. There is one investment that can provide guaranteed lifetime income: the fixed rate annuity (once annuitized) and we will probably see them used more often if other types of investments show volatility.

Stock market declines significantly affect the retirement plans of individuals who do not have guaranteed retirement income. It is necessary to know how much money will be available each month in retirement. Since many individuals plan to live entirely from their interest earnings, the ups and downs of stocks can be difficult to deal with when there is no steady income from a job.

Hoarding money in accounts that offer no or very small interest earnings is not the answer either since the assets may be losing value by not keeping pace with inflation. Earning adequate interest may make the difference between preserving principal and being forced to spend it.

Planning for retirement is not easy. It is difficult to find the most appropriate way to allocate assets and still avoid undue investment risk.

Debt

When living in retirement on a fixed-income, accumulated debt nearly always means financial stress. Once retired, it is most unlikely that the retiree will have more money tomorrow than he or she has today. Therefore, he or she absolutely must live on a budget and never spend more than is coming in each month or year.

At one time debt was a young person’s issue but that is no longer true. Retirees have learned to use their credit cards and the stigma attached to debt is not present today. On
average, the debt carried by U.S. households is equivalent to 100 percent of their personal disposable income. Nearly ten years ago a report by Demos, a New York-based advocacy group, found that self-reported debt among seniors (65 and older) grew by 89 percent between 1992 and 2001 to $4,041. For those aged 65 to 69, the news was worse. This group experienced a 217 percent jump in credit card debt to an average of $5,844. The trend has continued, with senior debt becoming a major problem as retirees are less prepared today than our grandparents were when they retired. Few retirees now retire without a mortgage; in fact, many carry both a mortgage and an equity loan on their home when they retire.

No individual should retire with high credit card debt. It would be better to delay retirement until all credit cards are paid off. Debt wastes money through interest and finance charges. The average family between the ages of 55 and 64 who carry credit card debt spend 31 percent of their income on servicing their debt. While that is certainly a senseless waste, it also means additional stress which can affect one’s health.

While debt is certainly a problem, it is made worse by the decline in savings. That may be a contributing factor to the increasing debt retirees acquire. Retirement income derived from assets has been steadily dropping over the last twenty years.

**Home Sweet Home**

A home mortgage does not necessarily cause concern in retirement if the retiree’s finances are solid in other areas. This means little or no credit card debt and low living expenses. A steady stream of income from pensions, personal savings, and Social Security will allow a comfortable lifestyle without stress if debt is low and day-to-day expenditures kept reasonable. The biggest mistake many new retirees make is over spending in the early years of retirement, leaving little to live on in the latter years of their retirement. Their reasoning is understandable: “I want to travel now while I am healthy enough to do so.” “I want my grandchild to be able to attend college.” “I have enough money; spending this today won’t affect it very much.”

Whatever the reasoning, retirement money must last a very long time and expenses are sure to rise as the years go by. Prescriptions will get more plentiful (and expensive), taxes will rise, and heating costs will go up. It will take more to live on as the years go by, not less.

**Saving for the Future**

Of course every American should be saving for their future, whether that happens to be a cushion against unemployment, a home purchase, or retirement. Some people save but do not do so wisely or with dedication. Perhaps it is a “put-and-take” account, where
money is deposited one month and withdrawn the next for something that is needed or simply desired. Perhaps they save, but then invest in a get-rich-quick scheme. We all know the old saying: if it sounds too good to be true, it probably is. Acquiring a sufficient financial cushion against hard times is not a “get-rich-quick” process; earning wealth (and keeping it) takes knowledge and hard work. The lazy man is unlikely to acquire or keep wealth. Even if an inheritance comes his way he will spend it or lose it quickly because he does not do what is necessary to make the dollars work for him.

The term “wealth” is vague. What one person considers wealth another may not. Wealth deals with monetary quantity and some people require more dollars than others do. The poor man is likely to view wealth differently than the rich man. A hungry man may be satisfied with enough to eat and a warm place to sleep while the rich man may not be satisfied at any point if earning wealth has overtaken his perspective on life.

There was a time when the retired population held much of the country’s assets but that is changing. In 1993 the average person between the ages of 55 and 64 had approximately $300,000 in assets.\(^4\) With decreased earning ability, lack of dedicated saving habits and a society that prefers to acquire goods, those now entering retirement have less than their parents or grandparents at this stage in life (this compares “actual value” of assets at retirement, not necessarily the actual dollar figure). Citizens are more likely today to keep their homes mortgaged whereas the goal in the past was paying off the home prior to retirement. Along with the rest of America, today’s current retirees are more likely to spend than to save. Along with the rest of America, today’s current retirees are more likely to be in debt, and struggle to make their monthly obligations.

While decreased retirement savings are an issue, it is not just the rate of saving versus spending that has made the difference. Income growth has certainly slowed and the average rate of interest is much lower today. Throw in the stock market declines and even those individuals who thought they had adequate retirement savings may no longer be in a secure financial position.

Retirement-age people have always remained in the workforce. Some enjoy working and do not want to retire; others must keep working because their retirement income is not sufficient to support them. Unfortunately most people do not begin planning for retirement soon enough so the amount of money set aside is inadequate. According to Money Magazine the average person does not begin saving for retirement until the age of 40. While twenty or twenty-five years, depending on retirement age, may seem like enough time to save for retirement, it seldom is. Few people put enough away to adequately supplement whatever benefits may be received from Social Security. It is easy to see why: if a couple is currently living on $80,000 per year and will live in retirement for twenty to thirty years, depending upon retirement age and their expected year of death, at minimum the couple will need to have saved between $1,600,000 and

\(^4\) The Urban Institute, a policy research group in Washington DC
$2,400,000 for twenty to thirty retirement years ($80,000 multiplied by either 20 or 30 years). This does not take into consideration inflation or additional medical costs that commonly occur during retirement, such as long-term nursing home care.

While a small amount saved routinely from the age of twenty is desirable the failure to do this is easy to understand. Following school, a college graduate is faced with thousands of dollars in college debt. Even if there is no college debt, the first working years will not be high-earning years. The new worker must establish themselves financially, which might mean having car payments, high mortgages, and child-rearing expenses. Saving even $20 per paycheck for future needs (including unemployment or a disabling injury) may not seem possible.

The lack of retirement planning seems to be universal among all income groups, but especially new workers may believe it is impossible to do. That doesn’t mean new workers should not still save; there will be other reasons to save besides retirement. Every person should put aside cash for emergencies, unemployment periods, or even a sudden and unexpected disability.

Those with higher incomes save no better than those with less monthly income. Insurance agents, like other business owners, may spend countless hours managing their business but spend virtually no time planning for a financially secure retirement. In fact, few people even have a written family budget, preferring to guess where their money goes. Few people could accurately say what they spend on dining out each month, the amount spent on clothing, or what they buy on impulse and unnecessary purchases. Often they do not even know how much their utility costs are each month.

One of the most important things a person can do financially is to sit down and study where they are spending their money. No written budget almost always equates into no savings account. It is difficult to save when the individual has no idea where he or she is spending.

A major reason people resist having a written family budget is resistance to responsible spending. Let’s face it: it is more fun to spend than save. It is easy to pull out the credit card and buy a new big screen television; there is much less satisfaction putting the same amount of money into a money market fund or annuity. The television is something that can be casually shown off to friends; few of us would whip out our portfolio to show our friends.

Some families do understand the need to minimize their spending because they have already experienced job downsizing. Unfortunately, unless that awareness came prior to job loss it may now be impossible to adequately prepare.

Those who are facing less income due to job loss, a new lower-paying job, or an increase in a particular expense (such as medical costs) must make difficult decisions.
relating to the family’s finances. This might mean giving up entertainment and eating out; it might even mean giving up a car and using public transportation. Even those who are currently not experiencing any financial fallout from the current economy must plan as though they could be affected at any time – because no one can be sure what tomorrow will bring.

It would be hard to find someone who is not aware of the current problems we are experiencing. Every day there are more reports of layoffs, cutbacks, and economic stress. There are fewer jobs, but more people searching for work, including those who have already retired and new college graduates. When we see reports of 600 people applying for a single low-paying position there is no doubt that it is tough to just pay the bills.

The economy fluctuates; this is an established truth. Knowing this doesn’t really make anyone feel any better if they are unemployed. Mid-20th century economist Joseph Schumpeter and others have suggested these fluctuations move in cycles, with periods of rapid economic growth and then periods of decline. Some professionals believe recessions are necessary since they bring us back to financial reality (let’s hope that is true for our government spenders as well), and pave the way for the next expansion. As painful as it is, a recession is a natural part of the economic cycle, especially when some values become excessively high, such as real estate. Eventually it turns around but in the meantime we must do what is necessary to financially survive. Part of that survival is reining in expenditures and giving up what is not necessary.

Ralph Waldo Emerson once wrote, “Do not go where the path may lead, go instead where there is no path and leave a trail.” Many who have recently experienced a job loss, the disappearance of retirement funds, or other economic results of today’s economy may need to blaze that new path, leaving their own trail. Agents may need to seek new types of insurance business, or seek out education in new fields to survive this economic climate. While others are intently focusing on economic despair and ruin, those who continue to make the best of what is available will see this time through. The same is true for our clients; there will be those who buy or invest nothing out of fear and those who look for the opportunities that are still available. The optimistic agent will find the optimistic clients and both shall survive to the recovery that will eventually come.

An Aging Nation

The United States is becoming a graying nation – there are more older people than ever before. Certainly we are living longer and that is part of the reason for our graying nation. We are also having fewer children as parents try to figure out how they will be able to support their children and maybe plan for college as well. While it may not seem that fewer children should affect us financially it eventually does. Each person receiving Social Security is not drawing on what they personally contributed; they are being supported by the working population. As we have continually fewer workers it becomes
Dollars and Sense

Chapter 1: The Reality

necessary for those that are working to contribute continually more dollars to support those who are retired. If the taxes workers pay increase, their ability to save for their own retirement becomes less likely.

It is when our children appear to be financially stable that we are most likely to begin saving for our retirement. Today’s children are finding it harder to become financially stable and are likely to rely on their parents far longer than they used to. Of course, some of the difficulty they are experiencing has to do with buying more than they should. Our parents tried to pay cash for the things they bought; if they didn’t have the cash they waited until they did. Today we are encouraged to acquire credit card debt; even the government wants us to spend to bolster the economy (ignoring the fact that debt is a severe problem in the United States). No one emphasizes saving money it seems. No one advocates waiting until a desired item is affordable.

There are some unfortunate statistics on money and retirement. According to the Social Security Administration, Social Security benefits account for 90 percent of income for four out of every 10 unmarried retirees and two out of every 10 married couples. The average monthly income from Social Security is around $1,100. When Medicare’s Part B payment is deducted it is even less. If Social Security monthly income is not supplemented by personal savings or a company pension, it means the recipient must live on just $12,000 per year. Due to the prosperity we have seen over the last fifty years, the average person expects to receive more from our society and the government, even though current times are clearly demonstrating financial difficulty. Our citizens believe they deserve more from their employer, the government, charitable organizations, or anyone who seems to have more than they do. Many Americans have lost the desire or focus to survive financially from their own efforts. Saving for the future certainly is not a priority even for those who should know better.

The solution is not likely to be government intervention (although the 2008 election certainly promised lots of intervention); it is likely to be a realization that we must prepare for our own futures. Countless financial experts have told us for years that we need to save for our retirement; our failure is not due to lack of knowledge. We have been told that we need to start early and have the discipline to leave the money alone. We know what we need to do, so why doesn’t the majority of people actually save? The simple answer is because it is hard to do and most people don’t want to do anything that is difficult. Even so, if one begins early it really isn’t all that hard to do. A 25 year old that sets aside $335 per month, without using it for anything else, will have more than a million dollars 40 years later at age 65. Yes, it will be difficult to do during the first ten years, but it does get easier as time goes by. The longer one waits the more difficult it becomes. If an individual does not begin saving until age 35 that same $335 per month produces only $500,000 or half what would have accumulated by starting at age 25.

How do we fail so miserably to set aside funds for retirement? There are many ways to fail. The major reason we fail to save is simple: we spend too much. Americans buy
more than any other nation and we buy things we don’t need and can’t afford. Much of our income goes towards credit card interest – money we are giving away to the credit card companies. The Employee Benefit Research Institute’s annual survey in March 2008 found that 22 percent of employees had not saved for retirement, or anything else.

Anyone who has a job must plan for their future. America cannot count on others or the government to care for them during retirement. In fact, we may find the government having difficulty meeting Social Security and Medicare/Medicaid expenditures. We may find our children and grandchildren tied down by such massive government debt that they are unable to spare the cash to take care of Grandma and Grandpa. America is changing from the world’s creditor to just another world debtor. In fact, America is now burdened by debt that is increasing dramatically in its attempt to bail out companies and industries that did a poor job of monitoring their business practices.

Since the early 1980s America has been spending without any thought to the future. Our spending has been largely subsidized by foreigners who have been financing more than half the Federal budget deficit. Foreign investors are also purchasing real estate and corporate stock, often at bargain prices since cities want their business.

Americans spend more than they earn, consume more than they produce, and go deeper in debt each year. As a result our standard of living has not risen since the early 1970’s. Between 1947 and 1973 average family incomes rose 111% but since then income has risen only 5 percent. Many economists believe it would not even have risen that much if wives had not entered the workforce. Only 20% of the nation’s households, those with incomes above $80,000, have gained ground on inflation since the early 1970s.

Our national debt has more than quadrupled since 1981 due to poor government management and simple greed. With the exception of the great depression, every generation that came of age in any decade in the nation’s history improved over their parent’s generation until the 1980s. Now each new generation faces the prospect of having a lower standard of living. Newsweek columnist Robert Samuelson observed: “prosperity is what binds us together; if we don’t all believe in a better tomorrow, America will become a progressively less civil, less cohesive and more contentious society.”

Individuals are not in a position to rein in government spending but we are in a position to secure our personal futures by refraining from buying every new gadget on the market and putting away some dollars for our future. We must do so if we are to have any shine in those golden years.
Using the Right People

There was a time when most people did their own goal-setting and saved in whatever method they felt appropriate. As financial options became better known specializations emerged. Professionals emerged in nearly every financial field, including insurance.

There are now many insurance designations that emphasis the specialized education they have achieved. Many of these professionals do not work on commission; they charge an hourly wage. These planners offer financial advice, but do not sell financial products. Their clients are paying for planner’s time and the specialized knowledge they have acquired.

There are financial planners that do work on commissions; it is important that the financial planner make the distinction clear to his or her clients prior to performing any work. There is certainly nothing wrong with earning a commission since everyone, including agents, deserves to make a living, but clients should clearly understand the difference early in the relationship.

Whether the financial planner works on an hourly basis or a commission basis, the first step is to assess how the client spends and currently saves. It is not unusual for the client to come to the planner expecting miracles. There are no miracles when it comes to saving for a future goal, whether that goal is retirement, buying a house, or saving for a child’s college education. If it were easy to save money everyone would be well financed in retirement and all children would attend college. Saving money is difficult!

Most people handle their money without recognition of where it is spent, what is obtained in return, and with no regard for future financial requirements. In other words, they spend in the immediate moment and worry about saving later (usually too late).

It can be difficult to change a client’s financial habits. The man that buys everything he momentarily wants, everything his friends have, or every new gadget that comes on the market will probably resist changing his habits. Let’s face it: spending is more fun than saving. For some, financial security will simply not be possible because they do not have the discipline required to achieve it. Their self-destructive spending habits will follow them into retirement and ultimately to the grave – literally. Study after study has shown that those who did not financially prepare for retirement are more likely to experience health problems and often die earlier than those that did financially prepare. While there are few statistics as to why non-savers die earlier, many believe their ability to care for themselves is limited because they lack financial resources in retirement. For example, they may not receive proper dental care, nutrition, or medical care, all of which would contribute to an earlier death.
Spenders seldom take the financial planner’s advice even though they may have paid an hourly rate to receive it. Since the advice does not fit their spending lifestyles they choose to ignore it, rationalizing why they are doing so:

“He just didn’t seem to really know me and my needs.”

“She expected me to give up the things I enjoy; I am not going to go without just to save a few dollars.”

“I don’t think he really knew his job. Bob saves on his own and I can do that, too.”

“Uncle Charlie has given me better advice and I don’t have to do without.”

The financial planners that work on an hourly or fee basis are often called Investment Advisors because they “advise” rather than sell. Some will charge by the hour; others have a set fee that is charged whether it takes an hour or a week to fully assess the client’s current financial situation, determine their goals, and create a financial plan.

It is not unusual for an advisor to be given complete authority to make buying and selling decisions for their wealthier clients, without prior consultation. On the other hand, many clients would never give such broad rights over their finances to another person; these clients what to be fully appraised before financial decisions are made on their behalf.

When an advisor has authority to financially act on behalf of another there is often a discretionary account created specifically for this purpose. The investor puts the amount of money they are willing to allow the advisor to work with into this account. Typically advisors state minimum amounts that must be put into the discretionary account; it is not worth their time to work with smaller amounts of money. The advisor will buy and sell securities, stocks or other financials on their client’s behalf without authorization or further consultation.

Compounding Power

It is the interest earnings that make early planning favorable. It is not a new concept: an individual who saves a little each month during all their working years (age 25 to 65) will be better off financially than those who try to save a lot in the last twenty years (age 45 to 65) prior to retirement. The additional twenty years of savings will mean twenty more years of interest earnings and compounding power. Interest or dividend earnings, kept at work (not withdrawn) earn additional interest or dividends. It becomes interest earning interest. Compounding power will partially offset inflation. Inflation removes value while interest earnings add value.
Retirement Income

According to the Social Security Bureau, income for those 65 and over comes from:

- Social Security income: 34%
- Earned income: 29%
- Assets/Accumulated capital: 15%
- Public pensions: 7%
- Private pensions: 5%
- Public assistance: 4%
- Veteran’s benefits: 3%
- All other sources: 2%
- Help from other people: 1%

Note that the second listing, earned income, means income from wages, so these retirees are still working. Certainly a portion may be working because they want to, but that may not necessarily be true for many of our working elderly. Many people would prefer to be traveling or golfing during their retirement but they do not have sufficient income, so instead they are saying “Welcome to Wal-Mart.”

Accumulated assets accounts for a low 15 percent - the only income that we actually have control over. Arguably it should be the highest category listed since it directly relates to what we have saved for retirement.

Americans have no problem spending money. Most of us expect to live by the same standards in retirement as we did when we worked. In fact, Americans are fantastic optimists. Even though the majority of Americans save far too little for retirement we cling to the optimistic belief that between Social Security, the company pension if we are lucky enough to have one, and some other mystical income source we will be fine. The question should be what will our sources of income be during retirement? The following are the most common sources of retirement income:

- Social Security Benefits
- Employer Pension Benefits
- Tax Deferred Retirement Benefits, such as IRA's and 401(k)'s
- Individual Savings
Social Security Benefits

During one’s working years each paycheck has FICA (Social Security) taxes withheld. It is a contribution to the fund that pays retirement, disability, survivor, and death benefits to individuals currently entitled to receive these benefits. The money withheld from a specific worker’s paychecks does NOT go to an account in his or her name. Current workers are paying Social Security benefits to those who are now retired or otherwise qualified to receive Social Security benefits. Each generation of workers will pay for those in retirement or receiving Social Security benefits due to a disability.

Age of Benefit Collection

No matter when the worker begins collecting his or her Social Security benefits, the system is designed to break even at around age 81. Therefore, whether reduced income begins at age 62, full benefits at ages 65-67, or delayed benefits at age 70, the value of the three options is designed to come out approximately the same by age 81. If an individual delays benefits and dies early less will have been received, but if the recipient lives past age 81, he or she comes out ahead.

Many high-earning workers may do well to delay receiving benefits, but lower paid workers may do best collecting at age 62, even though the monthly amount will be less than if they waited to full retirement age. Workers who earn more than $100,000 will see increased benefits as the maximum benefit rises, which may be a reason to delay benefits.

A person who continues to work past age 62, earning higher wages than previous years, may drop off lower-earning years. Social Security payments are based on the 35 highest-earning years in one’s career. For every additional year worked, the worker may drop off one of the lower-earning years.

The age at which Social Security benefits are collected is a personal decision and should be based on individual situations. Life expectancy should certainly be a consideration since nearly one-third of all women and one fifth of all men who live to age 60 will live into their nineties.5

Supplementing What We Have Saved

We all know we need more than Social Security to live comfortably in retirement. Social Security income is intended to supplement what we have done for ourselves. When Social Security was created no one realized citizens would end up living into their nineties or even to age 100. Since we are living much longer there is concern for Social

5 SSA.gov
Security funding. That has resulted in changing full retirement age for some individuals to age 66 or 67.

Even with Social Security income, many elderly people live in extreme poverty. Too many retirees are relying solely on Social Security since they did not save appropriately to supplement what they receive from the government. AARP reports that more than one-third of retirees depend on Social Security for 90% of their income. These figures leave little doubt that far too few workers are adequately planning for their retirements.

**Women Live Poorly in Retirement**

Any retiree could end up with too little to live on, but single, divorced, and widowed women seem especially vulnerable to this situation. Women comprise 73.4 percent of seniors who are considered poor. One out of four older women receives 90% of their income from Social Security and many of these women live in or near poverty.

No one should be surprised at these figures. Women were the primary caregivers not only for their children, but for their elderly parents as well. Women were more likely to leave the work force before establishing a pension, or work at multiple jobs that did not offer pensions. Combine less time in the work force with less earnings and the result is retirement poverty. A recent survey commissioned by MetLife's Mature Market Institute found that lost employment for care-giving translates into an average decrease in Social Security benefits of $2,160 per year, or $180 less per month.

Since Social Security benefits are based on earning history, many women have not accrued enough benefits over their lifetime to earn a sustainable income from Social Security. If they did not hold jobs that provided private pension programs then Social Security benefits are their only income, unless they were wise enough to prepare for retirement through personal savings. By the mid 1990's only 18% of women over age 65 were receiving private pensions. As fewer companies offer pensions, men are now finding themselves increasingly in the same position women have been in for years – without access to a company-sponsored pension.

Lifestyles were different when Social Security was designed in the 1930s. Husbands were the primary wage earners; most wives stayed home to take care of the home and children. Many things have changes since then, including the rising divorce rate (nearly half of all marriages end in divorce). According to the Social Security Administration, divorced, widowed, and never-married women depend heavily on Social Security for income in retirement. Social Security accounts for half or more of the income of nearly three-fourths of these non-married female recipients of Social Security. For one in four, it is the only source of income.
Social Security Benefits can be a significant source of income during retirement, depending on one’s retirement needs. The benefit received will directly reflect the amount paid into the system by the worker prior to retirement. Single low income workers (earning $30,000 or less) can expect Social Security benefits to provide 42% of retirement needs. A married low-income worker with a same age non-working spouse can expect Social Security to provide 63% of retirement needs. In contrast, a single high income worker ($100,000 or more) can expect Social Security to provide just 13.5% of retirement needs. A married high income worker with a same age non-working spouse can expect Social Security benefits to provide 20% of retirement income needs. The reason for this disparity is that there is a limit at which workers do not continue to pay Social Security taxes and the calculation of the retirement benefit is based on a decreasing percentage as the AIME (Average Indexed Monthly Earnings) increases.

**Primary Insurance Amount (PIA)**

The basic Social Security benefit is called the primary insurance amount (PIA). Typically the PIA is a function of *average indexed monthly earnings* (AIME). The PIA is determined by applying the PIA formula to AIME. The formula used depends on the year of first eligibility (age 62 in the case of retirement; disability would be any applicable age).

**Benefit Based on PIA and Age**

The amount of retirement benefits paid depends on a person's age when he or she begins receiving benefits. Social Security reduces benefits taken prior to the normal or full retirement age and increases benefits taken after normal or full retirement age.

**Other Methods for PIA**

Two other methods for computing a PIA exist. Relatively few new beneficiaries qualify for these two other methods.

**Calculations**

<table>
<thead>
<tr>
<th>Year</th>
<th>Case A, born in 1947</th>
<th>Case B, born in 1943</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Nominal earnings</td>
<td>Indexing factor</td>
</tr>
<tr>
<td>1969</td>
<td>$5,511</td>
<td>6.8556</td>
</tr>
<tr>
<td>1970</td>
<td>5,802</td>
<td>6.5315</td>
</tr>
<tr>
<td>1971</td>
<td>6,113</td>
<td>6.2190</td>
</tr>
<tr>
<td>1972</td>
<td>6,733</td>
<td>5.6639</td>
</tr>
<tr>
<td>1973</td>
<td>7,177</td>
<td>5.3304</td>
</tr>
</tbody>
</table>
When viewing the preceding chart you will see that Social Security illustrates calculation of retirement benefits using two examples, labeled case A and case B. In each case the worker retired in 2009. **Case A** was born in 1947 and retired at age 62. **Case B** was born in 1943 and retired at his normal or full retirement age. In each case, it is assumed the worker has covered earnings from 1969 through 2008, as shown in columns labeled "nominal earnings."

Indexing brings nominal earnings up to near-current wage levels. For each case, the table shows columns of earnings before and after indexing. Between these columns is a column showing the indexing factors. A factor will always equal one for the year in which the person attains age 60 and all later years. The indexing factor for a prior year $Y$
is the result of dividing the average wage index for the year in which the person attains age 60 by the average wage index for year $Y$. For example, the case A indexing factor for 1969 is the average wage for 2007 ($40,405.48) divided by the average wage for 1969 ($5,893.76).

**Average Indexed Monthly Earnings**

To compute an insured worker's benefit, first adjust or index his or her earnings to reflect the change in general wage levels that occurred during the worker's years of employment. Such indexation ensures that the worker's future benefits reflect the general rise in the standard of living that occurred during his or her working lifetime.

Up to 35 years of earnings are needed to compute the average indexed monthly earnings. After determining the number of earning years, Social Security chooses those years with the highest indexed earnings, adds up the indexed earnings, and divides the total amount by the total number of months in those years. This figure is then rounded to the resulting average amount (down to the next lower dollar amount). The result is the average indexed monthly earnings.

An insured worker becomes eligible for retirement benefits when he or she reaches age 62. If 2009 were the year of eligibility, for example, divide the national average wage index for 2007 ($40,405.48) by the national average wage index for each year prior to 2007 in which the worker had earnings and multiply each such ratio by the worker's earnings. This would give the indexed earnings for each year prior to 2007. Any earnings would be considered for 2007 or after at face value, without indexing. Next the average indexed monthly earnings are computed using the average amount in computing the worker's primary insurance amount for 2009.

The next step is to calculate benefits based on AIME amounts.

<table>
<thead>
<tr>
<th>Case</th>
<th>AIME</th>
<th>First</th>
<th>Second</th>
<th>Formula applied to AIME</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$3,370</td>
<td>$744</td>
<td>$4,483</td>
<td>$.9(744) + .32(3370 - 744) = $1,509.92</td>
</tr>
<tr>
<td>B</td>
<td>3,995</td>
<td>627</td>
<td>3,779</td>
<td>.9(627) + .32(3779 - 627) + .15(3995 - 3779) = $1,605.34</td>
</tr>
</tbody>
</table>

Because the worker in case A retired in 2009, and 2009 is the year in which the worker is first eligible for benefits, the case-A PIA (Primary Insurance Amount) is the case-A amount computed above truncated to the next lower dime, or $1,509.90.

The worker in case B is first eligible in 2005 (the year case B reached age 62). Thus the case-B PIA is the case B amount computed above truncated to the next lower dime and increased by cost-of-living adjustments, or COLAs, for 2005 through 2008. These
COLAs are 4.1 percent, 3.3 percent, 2.3 percent, 5.8 percent, respectively. The resulting PIA is $1,868.30.

Social Security assumes the worker in case-A began receiving benefits at age 62. Because case-A's full retirement age is 66, the benefit amount for case-A is reduced for 48 months of early retirement. The $1,509.90 PIA is therefore reduced to a monthly benefit of $1,132.

The benefit amount for case-B, assuming that benefits begin exactly at normal or full retirement age of 66, is not reduced except for rounding down to the next lower dollar. The $1,868.30 PIA is therefore reduced to a monthly benefit of $1,868.

Social Security also has benefit examples for workers whose earnings have equaled or exceeded maximum taxable amounts. These examples show AIME and benefit amounts for retirement at ages 62, 65, and 70.

The ordinary citizen is not going compute their Social Security earnings and it is not necessary for them to do so. Simply requesting this information from their local Social Security Administration office is sufficient.

Special Minimum Benefits

Social Security pays "special minimum" benefits to certain individuals who've had long periods of relatively low earnings. To qualify for these benefits, the individual must have at least 11 years of coverage. To earn a year of coverage, he or she must earn at least a certain proportion (25 percent for years prior to 1991, and 15 percent for years after 1990) of the “old-law” contribution and benefit base. Tables showing the range of special minimum primary insurance amounts and corresponding maximum family benefit amounts are available from the Social Security Administration.

Old-Law Benefit Tables

For individuals eligible before 1979, benefits are based on average earnings rather than average indexed earnings. Social Security determines the PIA for these beneficiaries from a specific benefit table, which is updated annually to reflect the latest automatic cost-of-living increase and the latest increase in the contribution and benefit base.

Also called the “old-law” benefit tables, tables used for eligibility prior to 1979 are available beginning with the table for the year 1959.

Summary

Social Security benefits are typically computed using "average indexed monthly earnings." This average summarizes up to 35 years of the worker's earnings. Social
Security applies a formula to this average to compute the primary insurance amount (PIA). The PIA is the basis for the benefits that are paid by Social Security to the individual.

The formula used to compute the Primary Insurance Amount, called the PIA formula, reflects changes in general wage levels, as measured by the national average wage index.

**Monthly Benefit Amounts**

Monthly retirement benefits derived from the PIA may be higher or lower than the PIA. Social Security pays reduced benefits to an individual who retires before his or her normal retirement age. A person cannot collect retirement benefits prior to age 62 unless payments are due to a qualified disability. In the case of a person retiring at exactly age 62 in 2009, for example, the benefit would be 25 percent less than the person's PIA since he or she retired before their full retirement age.

Benefits can be higher than the PIA if the worker retires after his or her normal or full retirement age. The credit given for delayed retirement will gradually reach 8 percent per year for those born after 1942.

In addition to retirement benefits, Social Security pays several other types of benefits. For example, Social Security pays benefits to disabled workers who meet medical and insured requirements. Benefits paid to disabled workers and their families may be reduced for receipt of certain public disability benefits (such as Workers' Compensation). In such cases, disability benefits are re-determined triennially.

Benefits to family members may be limited by a family maximum.

**Old Computing Methods**

Two other methods for computing retirement benefits were common in the past, but today have very limited applicability.

**Average Indexed Monthly Earnings**

The Average Indexed Monthly Earnings (AIME) is used in the United States’ Social Security system to calculate the primary insurance amount, which decides the value of benefits paid under Title II of the Social Security Act under the 1978 New Start Method. Specifically, Average Indexed Monthly Earnings is an average of monthly income received by a beneficiary during his or her work life, adjusted for inflation.

Each calendar year, each covered worker’s wages up to the Social Security Wage Base (SSWB) is recorded by the Social Security Administration in Baltimore, Maryland.
worker has 35 or fewer years of earnings, then the Average Indexed Monthly Earnings is the numerical average of those 35 years of covered wages; with zeros thrown into the average for the number of years less than 35.

For workers with more than 35 years of covered wages, the Average Indexed Monthly Earnings will only take the average of the 35 highest years of indexed covered wages. This figure is then divided by 12 to get a monthly rate. Thus the self-describing name "Average Indexed Monthly Earnings".

**Indexing Yearly Income**

Earnings in all years prior to two years before the current year are indexed for inflation. This is done by multiplying the amount credited to the Social Security earnings record in any given year by an indexing factor. The indexing factor is the ratio of the Wage Index two years before the current year to the Wage Index during the earnings year.

The following table shows the Wage Index in effect during each year.

<table>
<thead>
<tr>
<th>Year</th>
<th>Wage Index</th>
<th>Year</th>
<th>Wage Index</th>
<th>Year</th>
<th>Wage Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951</td>
<td>$2,799.16</td>
<td>1971</td>
<td>$6,497.08</td>
<td>1991</td>
<td>$21,811.60</td>
</tr>
<tr>
<td>1952</td>
<td>$2,973.32</td>
<td>1972</td>
<td>$7,133.80</td>
<td>1992</td>
<td>$22,935.42</td>
</tr>
<tr>
<td>1953</td>
<td>$3,139.44</td>
<td>1973</td>
<td>$7,580.16</td>
<td>1993</td>
<td>$23,132.67</td>
</tr>
<tr>
<td>1954</td>
<td>$3,155.64</td>
<td>1974</td>
<td>$8,030.76</td>
<td>1994</td>
<td>$23,753.53</td>
</tr>
<tr>
<td>1955</td>
<td>$3,301.44</td>
<td>1975</td>
<td>$8,630.92</td>
<td>1995</td>
<td>$24,705.66</td>
</tr>
<tr>
<td>1956</td>
<td>$3,532.36</td>
<td>1976</td>
<td>$9,226.48</td>
<td>1996</td>
<td>$25,913.90</td>
</tr>
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<td>1957</td>
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<td>1977</td>
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<td>1997</td>
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</tr>
<tr>
<td>1958</td>
<td>$3,673.80</td>
<td>1978</td>
<td>$10,556.03</td>
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<tr>
<td>1959</td>
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<td>1979</td>
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<td>$12,513.46</td>
<td>2000</td>
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</tr>
<tr>
<td>1961</td>
<td>$4,086.76</td>
<td>1981</td>
<td>$13,773.10</td>
<td>2001</td>
<td>$32,921.92</td>
</tr>
<tr>
<td>1962</td>
<td>$4,291.40</td>
<td>1982</td>
<td>$14,531.34</td>
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</tr>
<tr>
<td>1963</td>
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<td>1983</td>
<td>$15,239.24</td>
<td>2003</td>
<td>$34,064.95</td>
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<td>1985</td>
<td>$16,822.51</td>
<td>2005</td>
<td>$36,952.94</td>
</tr>
<tr>
<td>1966</td>
<td>$4,938.36</td>
<td>1986</td>
<td>$17,321.82</td>
<td>2006</td>
<td>$38,651.41</td>
</tr>
<tr>
<td>1967</td>
<td>$5,213.44</td>
<td>1987</td>
<td>$18,426.51</td>
<td>2007</td>
<td>$40,405.48</td>
</tr>
<tr>
<td>1968</td>
<td>$5,571.76</td>
<td>1988</td>
<td>$19,334.04</td>
<td></td>
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</tr>
<tr>
<td>1969</td>
<td>$5,893.76</td>
<td>1989</td>
<td>$20,099.55</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1970</td>
<td>$6,186.24</td>
<td>1990</td>
<td>$21,027.98</td>
<td></td>
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</table>
Thus the factor used in 2009 to index 1951 wages is 14.435 = $40,405.48 / $2,799.16, i.e. the ratio of the 2007 Wage Index (two years before 2009) to the 1951 Wage Index.

**Computation**

The following steps are used to determine the Average Indexed Monthly Earnings:

- Determine the Base Years (BY);
- Select the highest years of indexed and unindexed earnings to serve as computation Years (CY) in the amount of the number of BY;
- Add the indexed and unindexed earnings in the CYs to come up with the dividend;
- Divide the dividend by divisor months to get the Average Indexed Monthly Earnings;
- Round the Average Indexed Monthly Earnings down to the nearest dollar.

**Essentially, the more an individual earns the more he or she needs to provide for his or her own retirement needs.** Individuals can determine their expected Social Security benefits by accessing the Social Security Administration web site at http://www.ssa.gov/ and submitting a request for Form SSA-7004. Once this form is submitted, the individual will receive a detailed statement listing all of their earnings and expected benefits.6

**Employer Pension Benefits**

There was a time when the average worker expected their employer to provide for them in retirement. Besides a guaranteed monthly income, medical benefits might also be expected. Today this is much less likely to be true. Medical benefits in retirement became so costly that companies have mostly discontinued them. Employer pension benefits have also changed putting much of the responsibility for retirement income on the employee rather than the employer.

Some employers may have established a retirement plan that will pay retired workers a monthly amount over their retirement life or over the worker plus their spouse's joint life expectancy. There are many different types of pension plans. A typical plan is based on a stated percentage multiplied by the worker’s years of service with the employer and rate of compensation. For example, assume a retirement plan provides a retirement benefit equal to 1.5% times the number of years of service times the average of three of the highest years of consecutive compensation. If the individual worked for the employer for 30 years and the average of his or her highest three years of consecutive compensation was $50,000, then the annual retirement benefit would be $22,500 (1.5% X 30 X

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6 Social Security website
$50,000) or $1,875 per month. Retirement plans vary in design so it is important to understand how each plan’s particular benefits are calculated when determining the exact retirement income amount.

Retirement plans promising to pay a specific dollar benefit during retirement are known as defined benefit plans because the retirement benefit is defined. The employer is typically responsible for the investment and actuarial funding of these retirement plans. Other plans place the responsibility for retirement income on the employee. It is not surprising that companies are increasingly favoring this avenue since it removes their responsibility for supporting their retired employees. The employer only specifies the amount that is to be contributed to the retirement plan; the employee must do the contributing, although there may be matching company funds. These plans are known as defined contribution plans because the contributions (not the retirement benefits) are defined. The source of income during retirement depends on the employer contributions, if any, and the tax deferred earnings on the balance in the investment account. A defined contribution plan offers no guarantee as to the balance in the employee's account. Inadequate funding, bad investing or poor earnings performance may have detrimental effects on the amount available at retirement.

Tax Deferred Retirement Benefits (IRA's, 401(k)’s, 403(b)’s)

Individuals can fund their own retirement through a variety of tax deferred retirement plans. Some are funded by contributions or salary reductions. Employers may also offer employees a 401(k) plan, also known as a CODA (Cash or Deferred Arrangement). Employees can contribute more to a 401(k) plan than to a traditional IRA and employers will sometimes match employee contributions up to a certain percentage. Contributions to a 401(k) plan are tax deferred and any investment earnings are tax deferred. Certainly this is generally an advantage over personal after-tax savings. Employees are responsible for selecting the investment vehicle and there is no guarantee as to the savings accumulation in the account. Certain tax-exempt private organizations, public schools, and colleges may offer a variation of the 401(k), known as a 403(b). These types of plans are similar in concept to the 401(k) plan.

IRA’s are generally available to individuals who are not participants in an employer sponsored plan. The amounts individuals can contribute to an IRA is lower than vehicles such as a 401(k) plan.

Individual Savings

Not all retirement plans provide tax advantages. Saving in any form for any goal is beneficial. Individual savings is generally a more difficult way to accumulate retirement funds since there is no tax deduction or tax deferral on earnings but the bigger obstacle to
saving for retirement is the tendency to spend all take home pay rather than saving a portion of it for retirement. However, if the individual has the dedication to “pay himself first” (i.e. transfer money to savings before spending it) then this could be a significant source of retirement income.

**Managing Income in Retirement**

Managing our income is always important, but it becomes even more critical during retirement. At this point there is typically only savings – not wages. Financial mistakes made while one is earning wages may be disappointing, but the same mistakes made with savings during retirement can be financially catastrophic. Because sources of retirement income are limited, careless spending may be the difference between comfort and poverty in the final retirement years. The retiree must ensure their retirement (savings) income lasts through their total retirement years – not just the first ten years, for example. This means determining income needs in the years leading up to retirement and once retired, efficiently managing retirement assets so they last as long as the retired individual does. For many, this means resting their income sources in financial vehicles that will preserve their assets throughout their lifetime, such as lifetime annuities.

**Pre-Retirement Income**

The prudent worker will save throughout their working career for their retirement, but realistically most people do not begin saving for retirement until they reach age 40 (making the savings goal far more difficult to achieve). Consequently, as retirement nears there is always the chance that too little was saved to finance their retirement years. Besides simply saving too little, other factors may contribute to the retirement shortfall including higher cost-of-living prior to retirement (so not enough was saved to make up the difference) and lower-than-projected returns on investments. To increase the chances of having a financially secure retirement it is necessary to make frequent reassessments during the 10 years prior to retirement and make adjustments as necessary.

Workers often complain that it is increasingly difficult to save sufficiently for retirement when current costs of living eat up what they would have otherwise saved. There is no doubt that it can be difficult to save enough for thirty years of retirement. Of course, that is why the prudent worker begins as soon as he or she acquires a full-time job – usually in their twenties. Beginning so early allows the worker to save a smaller quantity of their income each month. Having said that, the worker who waits until age 40 to begin saving for their retirement must simply be prepared to make sacrifices if he or she is to have sufficient retirement income. Since most of us will not have a rich uncle or win the lottery there is no other choice. We either save enough to live comfortably during retirement or we do without in our final years. State and federal budgets are strained
already and there is no reason to believe it will get any better. That equates into the
government doing less for their retired citizens – not more.

The performance of the stock market in the last fifteen years has required many people
nearing retirement to make changes in their retirement planning. Those who relied on the
continued boon of the early 90s for their retirement income found their optimism crushed.
Of course, the market downturn resulted in a significant reduction in retirement assets for
those both facing retirement and currently in retirement. Some were forced to postpone
their originally anticipated retirement date while many people in retirement found it
necessary to return to work. Returning to work makes sense if the retirement nest-egg
will be depleted too quickly. The younger the retiree is the easier it is to return to work;
older retirees may find it medically impossible or there may be no job available for them,
especially in some industries that change rapidly making their skills obsolete.

Retirement Shortfalls

It is always better to have saved too much for retirement than not enough. Additionally
some people are more content than others, meaning some people are satisfied reading a
good library book while others are determined to travel. These retirement expectations
must be considered prior to retirement, saving accordingly. If a reassessment of the
retirement portfolio and current cost-of-living reveals a shortfall in savings, it may be
necessary to continue working beyond the anticipated retirement date. If the worker
decides to work longer he or she must be cognizant of how the additional income could
affect the amount received from social security if under the full retirement age as
determined by the Social Security Administration. There are maximum amounts that can
be earned without losing social security benefits. If income exceeds these amounts,
Social Security benefits are reduced by $1 for each $2 earned. Once full retirement age is
reached, income will not affect social security benefits.

At one time, full retirement age was 65. However, beginning with people born in 1938
or later, that age gradually increases until it reaches 67 for people born after 1959. The
following chart shows the steps in which the age will increase:

<table>
<thead>
<tr>
<th>Year of Birth</th>
<th>Full Retirement Age</th>
</tr>
</thead>
<tbody>
<tr>
<td>1937 or earlier</td>
<td>65</td>
</tr>
<tr>
<td>1938</td>
<td>65 and 2 months</td>
</tr>
<tr>
<td>1939</td>
<td>65 and 4 months</td>
</tr>
<tr>
<td>1940</td>
<td>65 and 6 months</td>
</tr>
<tr>
<td>1941</td>
<td>65 and 8 months</td>
</tr>
<tr>
<td>1942</td>
<td>65 and 10 months</td>
</tr>
<tr>
<td>1943-1954</td>
<td>66</td>
</tr>
</tbody>
</table>
When Social Security was just getting started back in 1935, the average American's life expectancy was just under age 60. Today it is more than 25 percent longer; the average life expectancy is now just over 76 years old. That means workers have more time for retirement, and more time to collect Social Security benefits. As a result Social Security's retirement age is gradually changing to keep pace with increases in longevity and expected benefits collected. Workers born before January 2, 1938 can collect full benefits at age 65. For those born after that date, the age to collect full benefits is gradually being raised to age 67. 

Social Security income was never designed to fully support an individual or couple during their retirement years. Social Security is intended to supplement whatever the person did for themselves, whether that happens to be a company-sponsored pension or private savings. When Social Security was first developed many Americans did believe it would fully support them but we now know it is not enough to live on.

If a worker discovers he or she cannot financially retire as early as planned and must continue to work, the individual will likely also need to increase the amount saved for retirement. Increasing retirement savings late in one’s working career is not always easy but it is often necessary.

Many of the steps advised are similar to prudent financial planning at all ages. For example, most financial planners recommend that credit cards and other loans be paid off prior to retirement. This is actually good advice for all ages, not just retirees. Even so, it especially applies to those entering retirement. If the individual goes into retirement without debt he or she does not have the burden of paying for purchases made during employment (when wages were being earned). If the home is also paid off, the retiree has no debt, freeing their funds for other activities. Only costs for such things as food, gas, insurance, utilities, property taxes and clothing remains.

If a mortgage remains at retirement it is unlikely that it can be paid off so that must be factored in with living costs. If the retiree cannot make the mortgage payment and still have enough to live on comfortably he or she may want to consider selling their home and either buying a smaller home if there is sufficient equity to do so, or perhaps move to a less expensive apartment (paying rent).

Note: Persons born on January 1 of any year should refer to the full retirement age for the previous year.

<table>
<thead>
<tr>
<th>Year</th>
<th>Full Retirement Age</th>
</tr>
</thead>
<tbody>
<tr>
<td>1955</td>
<td>66 and 2 months</td>
</tr>
<tr>
<td>1956</td>
<td>66 and 4 months</td>
</tr>
<tr>
<td>1957</td>
<td>66 and 6 months</td>
</tr>
<tr>
<td>1958</td>
<td>66 and 8 months</td>
</tr>
<tr>
<td>1959</td>
<td>66 and 10 months</td>
</tr>
<tr>
<td>1960 or later</td>
<td>67</td>
</tr>
</tbody>
</table>

Social Security website
Reverse mortgages are often considered at some point as a means of funding retirement. HUD’s Federal Housing Administration (FHA) created one of the first reverse mortgages available. The Home Equity Conversion Mortgage (HECM) is FHA’s reverse mortgage program that makes home equity available. Many retirees use the HECM to supplement their Social Security and savings, especially if unexpected medical bills exist.

Specifically, a reverse mortgage is a type of home loan that allows the home owner to convert a portion of their equity into available cash. Unlike a traditional home equity loan or second mortgage, no repayment is required until the borrower no longer uses the home as their principal residence. Repayment is not due until the home is no longer the principal residence, but when that occurs repayment will be required. If the home is sold, either the homeowner or the estate will repay the cash that was received from the reverse mortgage (plus interest and other fees) to the lender. Any remaining equity will go to the homeowner or the heirs, if the homeowner is deceased.

As long as the homeowner lives in the residence (and keeps the taxes and insurance paid) repayment is not necessary. The homeowner may never borrow more than the value of the home. The amount borrowed depends on the borrower’s age, the current interest rate, and the appraised value of the home. Sometimes there may be FHA mortgage limits for the area where the home is located. Generally, the more valuable the home is, the older the borrower is, and the lower the interest rate, the more equity there will be to borrow.

**Getting a Return on Savings**

Prior to retirement individuals will be wise to make spending changes that reduces or eliminates luxury items and unnecessary spending. This might include buying a less expensive car, eliminating some activities that are costly, or selling items that incur extra costs (such as memberships or vacation property). While it may seem to the worker that he or she is giving up some aspects of their lifestyle it will eliminate many stresses that would otherwise exist in retirement.

Experienced financial planners always suggest making our money work for us, but many consumers do not understand just what that means. Obviously this advice applies to both our working years and our retirement years. Generally this means making our assets work in our favor by producing a return on whatever investments we may have. It might be an IRA or an annuity for example, that provides additional income or assets in the form of tax-favored returns.

Safety of retirement assets is very important. During our working career we can take chances with our investments in hopes of earning higher returns. If the investment loses value instead of gaining value we have time to recoup our losses because we are still...
earning wages. During retirement we no longer have wages (continued income) so it is important to seek safety for our savings. This might equate into a shift from risk vehicles to those that produce a guaranteed rate of return, such as fixed rate annuities. The actual allocation depends on the number of years the individual plans to stay in retirement. Some individuals may have saved so meagerly for retirement that they feel they must use aggressive investing even during their retirement years in order to have enough funds throughout retirement. There is certainly danger in this since a poor choice in investments can potentially wipe out all retirement savings.

When reallocating investment funds for retirement safety it is important to consider the level of liquidity. Older Americans probably do not want to enter into a long-term investment unless there is the ability to access funds if necessary. Some types of investments require more than a year to liquidate. Reallocating assets without attention to liquidity may leave the retiree without necessary cash for day-to-day expenses. It is not just the daily expenses that might be affected by placing assets in difficult-to-liquidate accounts. There have been cases of individuals not meeting their required minimum distribution requirements, for example, because assets could not be liquidated in time.

If the retiree looks objectively at the length of time they will be retired he or she must develop some formula to make their funds last to the end of his or her life. This will be based upon the combination of the current cost-of-living with increases in costs considered, the amount they managed to save, and the amount of years projected in retirement. Obviously the retiree should not spend their entire retirement nest-egg too soon since that would leave their final years with nothing but Social Security income. To balance income with expenses, the retiree might consider doing the following:

- Make a list of monthly expenses, including utilities, groceries, rent or property taxes and transportation. It is wise to also consider medical and leisure expenses since it is likely that such expenditures will be made in retirement. Costs-of-living are likely to increase over time, which means the retiree must do an assessment at the beginning of each year to determine if he or she needs to adjust how they spend and eliminate expenses. In general, inflation increases about 3% per year, but it could be higher for certain expenses – especially for medical care. Retirees must consider long-term medical costs, such as care in a nursing home. Government agencies will only cover these costs if the retiree has spent all their own assets first (unless they have bought a Partnership long-term care policy to preserve assets) from Medicaid spend-down requirements.

- Take stock of the amount saved for retirement. This includes regular savings, retirement savings, pensions, annuities, or other usable assets. The retiree should include Social Security income in this analysis.

- Consider the amount of years the retiree expects to be retired. Obviously he or she cannot say how long they will live, but a person who plans to retire at age 60
must plan differently than the person who plans to retire at age 68. We also recommend that the individual plan their future as an optimist would – assuming they will live at least to the average life span of age 76. If their parents and other relatives lived into their eighties, then this is the age span that should be considered. While no one can predict their longevity, family history will certainly play a role. Newer studies suggest, however, that only 20 percent of longevity is based on family genes, with the remaining 80 percent coming from lifestyle (eating habits, stress factors, exercise, and so forth).

The last two factors combined determine how much monthly income the retiree can access each month to make their savings last to the end of their life. Consider the amount saved versus the number of years expected in retirement. Assuming the retiree will live in retirement for 20 years and he or she has saved $500,000, the monthly allocation would be approximately $2,100. Add this amount to the amount the retiree will receive from Social Security. That provides the amount of income available to cover monthly expenses, including health care costs that may develop with increasing age. To estimate income from social security, use the benefit calculators at the Social Security Administration’s website or request a written report from Social Security. During each year of retirement it is necessary to look at current expenses and spending habits to determine if adjustments must be made. The golfing that seemed affordable in the first years of retirement may no longer be affordable five years later. Such sacrifices are essential to enable the retiree to meet necessary expenses throughout their retirement years. It is far better to be able to afford prescriptions later in life than golfing in the early retirement years.

Women must especially plan for their retirement years. Single women make up the majority of impoverished retirees. They are less likely than men to have a sufficient retirement fund. Women are less likely to have company pension plans since they take time off work to raise children and may also leave jobs to follow their husband’s career or take care of elderly parents. Because women earn less, their other retirement incomes, including Social Security, also tends to be less than adequate.

**Receiving Income from Investment Vehicles**

It is not surprising that the amount of income received in retirement will depend upon the amount of money saved during one’s working years. How one saved will depend upon the individual’s selected financial vehicles (annuities, stocks, bonds, and so forth). Most financial planners recommend that several types of financial vehicles be utilized to cushion against the ups and downs of the financial markets. Usually we refer to this as not “putting all our eggs in one basket.” When we utilize multiple baskets, if one basket falls breaking the eggs it holds, we still have other baskets and eggs remaining.
Once in retirement, individuals should consider withdrawing no more from retirement accounts than necessary or required each year by IRS regulations. This allows remaining amounts to continue growing tax-deferred, or tax-free in the case of Roth IRAs. This also helps to reduce the amount the retiree must include in his or her income, thereby reducing the amount of taxes possibly owed for the year. There is another reason to withdraw only what is necessary for expenditures: if excess cash is withdrawn it is likely it will also be spent. By resisting the urge to withdraw more than actually necessary it may prevent excessive spending.

It is always important to follow required distribution requirements for qualified financial vehicles. If the amount withdrawn from retirement accounts for the year is less than the required minimum distribution (RMD), the IRS may impose a penalty of 50% of the shortfall, referred to as an excess-accumulation penalty. Establishing scheduled distributions (versus occasional distributions) helps ensure not only that the RMD is distributed on a timely basis, but also that payments will be received without having to contact the financial institution each month or each time a withdrawal is desired.

**Taxation**

When determining annual expenses and income, it is important to remember that the retiree might be responsible for paying income taxes on amounts withdrawn from tax-deferred retirement accounts, such as annuities and some types of Individual Retirement Accounts. These amounts will be treated as ordinary income for tax purposes. The retiree may want to consult with a tax attorney or accountant to minimize taxation. An agent should never attempt to provide tax advice unless he or she is qualified by experience or education to do so.

**Withdrawals Prior to Age 59½**

Some types of retirement saving vehicles have age restrictions on withdrawals. Since the goal is retirement, penalties are placed on withdrawals made prior to age 59½, since it is assumed that is prior to retirement. Generally the penalty is 10% and may be called an excise tax. Penalties may be waived if the investor meets one of the exceptions allowed by IRS regulations. This penalty or excise tax is charged in addition to any income taxes owed on the amount. It is also in addition to any early withdrawal penalties levied by the issuing institution (an insurance company in the case of annuities). If the retiree must distribute amounts from his or her retirement account prior to age 59½ he or she should talk with their accountant, financial planner, or tax attorney about strategies to avoid or minimize the IRS penalty.

Managing retirement income requires careful and thoughtful planning. Waiting to plan until retirement actually arrives is foolish since many of the strategies that would
otherwise have been available may not be used at that late date. Financial plans should be reassessed during pre-retirement years to minimize damage from changes, such as higher than anticipated living costs, or reduced asset growth. Talk with a financial planner to determine specific goals or needs and to maintain a realistic approach to reaching retirement financial goals. Retirement will come whether the worker saves for those years or not. It is not a question of whether or not retirement age will arrive; it is a question of whether or not retirement will be golden.
Medicare Supplemental Insurance

Every individual is aware that our health is likely to deteriorate as we age. Few elderly Americans would be willing to bear the risk of living without health insurance once they retire; luckily they don’t have to since we have socialized medicine in the form of Medicare. Most people who qualify for Medicare also carry private insurance to supplement Medicare’s coverage, appropriately named Medicare supplemental insurance. Rather than traditional Medicare supplemental coverage, many retirees are now opting for Medicare Advantage plans that incorporate Medicare with private insurance.

Today there are four parts to Medicare: Part A (hospital), Part B (medical), Part C (advantage plans), and Part D (prescriptions).

Part A of Medicare is called hospital insurance because it covers costs associated with care in the hospital as an admitted patient. Part A will also cover (if the patient medically qualifies) some amount of skilled nursing home care and home health care. No individual should assume nursing home confinements will be paid by Medicare. Medicare covers only skilled care, not custodial or intermediate care, which is the type most people need. There is no cost for Medicare Part A as long as the individual or their spouse paid Medicare taxes during their working years. If the individual did not pay into the system Part A may be purchased.

Part B of Medicare is called medical insurance because it covers medically necessary physician fees and outpatient care. Part B will cover some preventative services, emergency ground transportation (ambulance), laboratory fees, and blood transfusions as well. For a detailed list of all that is covered, the beneficiary should refer to their Medicare & You handbook supplied by the Department of Health & Human Services. There is a cost for Part B of Medicare and this amount is usually deducted from the individual’s Social Security check each month. The amount is usually a standard amount that everyone pays, but premiums might be higher if:

1. The individual is single, filing an individual tax return, with a yearly modified adjusted gross income of more than a specified amount.
2. The individual is married, filing a joint tax return, and the couple’s yearly modified adjusted gross income is more than a specified amount, which is double the rate for an individual (since there are two people rather than one).

Medicare will notify the individual if he or she must pay a higher amount.

Part B has a deductible each year that must be met before Medicare begins paying its share. Medicare then pays 80% of the Medicare-approved amount. The remaining 20% and any amount above what Medicare has approved for the service must be paid out-of-pocket if the beneficiary has not purchased additional insurance to pay the differences between what the service cost and the amount Medicare paid.

With the creation of Part C of Medicare, there are now references to the “Original Medicare” and “Medicare Advantage Plans.” Under the Original Medicare plans Medicare deals directly with the beneficiary whereas under Advantage plans Medicare deals directly with the insurer (Health Maintenance Organization or Preferred Provider Organization, for example). Even under the original plans, however, the doctors and medical suppliers must bill Medicare on behalf of their patients. Advantage plans receive a monthly payment from Medicare; they must then supply the medical care for this amount, plus whatever premiums and fees are charged to their patients. Medicare will never pay more than the agreed upon monthly fees.

Although all companies that work with Medicare to provide Part C Advantage Plans will have some common elements, all companies are not the same and do not necessarily provide the same benefits. Both benefits and costs can vary widely. There are likely to be co-insurance requirements and deductibles, especially when hospitalization occurs. An individual with End-Stage Renal Disease (ESRD) generally cannot join and receive care through Part C Advantage plans. It may only be possible to join Advantage plans at specified times, unless the individual is just now becoming eligible for Medicare (turning 65 years old).

Part D of Medicare is for prescription drug coverage. Many of the Part C Advantage Plans incorporate prescription drug coverage into their plans so buying additional Part D coverage is not necessary. If prescriptions are not provided through another avenue, those on Medicare can elect to purchase Part D coverage so their prescriptions will be paid for (deductibles and copayments generally apply). Typically, those who choose the Original Medicare plans would be the individuals who would elect to buy Part D coverage separately. Part D coverage is available through private companies that work with Medicare to provide prescription drug benefits. Whether Part D prescription coverage is obtained privately or through an Advantage plan, they are called “Medicare Drug Plans.” If the beneficiary does not join a Part D plan when he or she is first eligible, he or she will pay a higher rate if they join later on. This higher rate is due to the penalty for late enrollment that is added to the premiums.
Long-Term Care Insurance

Most people are aware of the Medicare benefits that are available. As we age we may need another type of insurance coverage unless we are wealthy enough to pay for long-term services out-of-pocket: long-term care in an institution or other setting.

Definitions of long-term care will vary depending upon the context in which it is used. Federal guidelines define it as care received for at least 90 days or more. Long-term care involves care that is necessary due to frailty, physical disability, or cognitive impairment such as Alzheimer’s disease. We usually think of long-term care involving older Americans but we are seeing an increasing number of younger individuals requiring care for a long period of time, perhaps even until their death. Those who require long-term care typically need help with the daily activities of life. This would include bathing, dressing, toileting, eating, transferring from beds to chairs, and general supervision. Insurance policies refer to “activities of daily living” or ADLs and will state a specified number of activities and provide definitions of each. Care may often be provided by individuals with only modest medical training rather than highly skilled nurses.

Long-term care can be very expensive. It is not unusual for costs to run $6,000 or more per month, although actual cost will depend upon the services provided and where the care is received. There are many variables when it comes to cost. While it is possible for some people to manage such costs without insurance, people are increasingly turning to insurance to cover the risk. Long-term care insurance is costly but just a few months in a nursing home will more than pay back the cost of the premiums. Consumers who decide to purchase a long-term care policy will make decisions regarding daily policy benefits, length of insured stay, and even whether or not they protect their assets through the purchase of the long-term care policy. Federally promoted “Partnership” policies will provide asset protection even if the insured ends up needing to apply for Medicaid benefits because their own policy benefits have been exhausted. Although four states have had such Partnership policies for some time, the majority of states only had the opportunity to provide asset protection since the passage of the Deficit Reduction Act of 2005. Each state then must pass legislation dealing with Medicaid funding and asset recuperation before the Partnership asset-protecting policies may be sold.

Since premiums for long-term care policies are based upon the benefits purchased, the more the consumer wants the more the policy will cost. There was a time when financial planners did not see the need to purchase long-term care coverage, but that is changing. Today’s financial planners realize that with longer life comes greater potential of needing some amount of long-term care. Since such care is very expensive, especially in the types of settings that most of us would prefer, long-term care insurance seems prudent. As a result we are seeing this type of insurance increase in sales despite the cost.
Forward Planning

Most of us plan our vacation far better than we plan our retirement. Most of us go to work every day, put in our eight hours, go home and repeat this routine over and over all our working lives. When we know a vacation is coming, however, we probably spend several hours going over our options: where we will stay, the route we want to drive, and the activities we want to participate in. The few hours we spend on these plans do not alter our lives. The grass is still mowed, the dishes are still washed, and the kids still get to school.

If each American spent only an hour each month looking over their retirement accounts, creating meaningful goals, and monitoring their steps in getting to those goals, retirement would be much easier financially. Of course, this could be applied to any financial goal, whether it is a college education for the children or a down payment on a house.

We are told that Americans are very poor savers in general. We are more likely to max out our credit cards than any other country, more likely to spend than save, and more likely to wait for the winning jackpot in a lottery drawing. It isn’t that we don’t know we need to save for retirement; no person who opens a newspaper or listens to the news on television could avoid hearing the statistics. Perhaps we are just very good at denying the obvious: we must live somehow once we quit working.

Some interesting facts that will affect everyone’s retirement:

- Social Security is not meant to be an individual’s sole support in retirement; it is merely a supplement to what one does for him or herself. However, it provided greater support for our grandparents than that available for us. Besides receiving less in relation to the current dollar’s value, we want more today than our grandparents did. Our country is financially struggling and we can expect to receive increasingly less as more retirees than originally anticipated seek benefits. Social Security will provide an ever shrinking amount of retirement income. We must rely on our personal savings and investments more as time goes on, not less.

- There was a time when women expected to be supported by their husband. Of course that is no longer true. As we have expected more material things in our lives and as the divorce rate rose to nearly half of all marriages, women now work outside the home as much as men do. A large percentage of women will be on their own through divorce, death, or the choice of remaining single. Of course, these women must rely on themselves financially.

- We are living longer than our grandparents did. Therefore, today’s retirees must have more financial retirement resources than their grandparents needed. Women live approximately six years longer than men (and men tend to marry younger
women), so the retirement funds must last through her life as well as his. Consideration of this fact is essential when making pension income decisions.

- Our parents will live longer than our grandparents; it is very possible that we might be caring for elderly parents into and during our own retirements. The responsibility of caring for our parents during our own retirement means extra responsibility, some of it possibly financial, that we did not anticipate during our working years. We may find ourselves paying for our elderly mother’s prescriptions, or supplementing her meager income so she can stay in her own home longer.

If we are to live comfortably in retirement the only option is to make financial goals and keep them. Otherwise those retirement years may feel more like prison steel than a golden retirement.

**Become Involved**

Suze Orman writes in her book *Women & Money* that she finds women often fail to take the time to educate themselves in finance. Men may gain financial experience in the workplace; women traditionally have not had the same opportunity so they must seek knowledge. That doesn’t mean investors (men and women) must become experts in the investing field, but they do owe it to themselves to learn enough to make wise decisions. Whether or not our clients have any financial education, every financial planner and agent has a professional duty to do the best possible job for each of their clients. There is no acceptable excuse for performing poorly. An informed investor will make better choices than the uneducated person, so agents may be wise to provide as much knowledge as practical. If the client makes better choices, the agent or financial planner will be able to do a better job as well.

Agents and financial planners must be aware of their client’s goals. What the client wishes to accomplish through the investment often makes the professional’s job easier since he or she has a clear view of the objective. Clients may feel disappointed in the professional’s performance if their objectives are not met, but if the agent or planner did not understand the client’s intent how can he or she help them arrive there?

**Safety and Security**

As a worker nears retirement he or she is generally seeking safety of funds. When an individual is young, he or she can afford risk since there is time to make up losses. This is not necessarily possible as the individual nears retirement since time is no longer on their side. In multiple studies consumers have said that safety is more important than
return as they near or enter retirement. In other words, the investor is more concerned that their principal stays intact than they are with earning higher interest.

Many families do not discuss finances even with each other so it is difficult to effectively discuss them with their agent. Agents must find ways to bring out their client’s goals and concerns in a relatively short time period. Certainly people are concerned with having enough assets to last until their death, but the details necessary to arrive there may not be voiced.

The insurance producer’s or planner’s job is often made easier when a worker nearing retirement has already discussed their financial position with their children. Having gone over the details once with family members makes the total picture clearer in their minds so they can more readily relay their goals and concerns to their agent. Unfortunately many families do not discuss finances. Parents are concerned their children may be greedy if there could be an inheritance; children are fearful that their parents may perceive them as greedy if they ask questions. Therefore, nothing is spoken and no one in the family knows the financial circumstances of the other.

One reason parents and children should discuss the financial position of the parents has to do with the future. Children need to know how their parents would like to live when health and cognitive functions may not be as strong as they are today. Does the parent wish to remain at home, even if that means live-in care? If a nursing home becomes necessary, does the parent have preferences of location? If the parent can no longer manage their assets, which child should do so? Especially important is a list of all assets so the child can manage them effectively. If children do not know what assets their parents have an outside party could exploit them once the parent develops a cognitive impairment; the children may never be aware it even happened.

It can be difficult talking about future incapacities but doing so may make all the difference for those dealing with the situation. Children may not realize what their parents would have wanted or where all their assets are located.

**An Emergency Fund**

For decades financial planners have told their clients to keep enough cash in a readily accessible account to cover living expenses for at least 90 days. This fund is for paying bills and putting food on the table if an emergency arises that prevents working. It might be an illness, an injury, or the loss of a job.

If an individual earns $2,000 per month a 90-day emergency fund would require $6,000 in liquid assets. By “liquid” we mean in an account that can be easily accessed without incurring penalties. Obviously such things as annuities would not be sensible for an emergency fund. Financial planners are now frequently recommending six to nine
months of living expenses be kept in an emergency fund since it commonly takes that long to find a job following a layoff.

If the individual earns $5,000 per month but his or her bills are only half that amount he or she could save just the amount that is required to pay the bills but it is important to be sure half that amount ($2,500) would realistically pay all the bills, including credit card charges and insurance or other costs that come due only once or twice a year. If a bill comes due quarterly, two quarters should be considered when figuring the amount that needs to be in the emergency fund. It is always better to have saved more than necessary than less. Losing a job is stressful; the inability to pay all the bills will make that stress far worse. For years we have heard that most Americans are only one paycheck away from disaster but few seem motivated to do anything to correct this situation.

Most people realize it is wise to have an emergency fund but all too often they never get around to creating one. There is little an agent can do past showing clients how to create and keep such an account.

**Durable Power of Attorney**

A **durable power of attorney** is an estate planning tool that is an absolute must for every person regardless of their age. It is a simple form appointing someone else to make decisions and exercise financial rights under specific conditions. The person appointed need not be a family member. This power is called **durable** because it remains effective even after the person who signed it becomes incompetent and cannot, as a result of the incompetency, manage his or her own affairs.

**Estate Planning Tools**

There are many estate planning tools that may be used to accomplish a smooth transition through the final years of life and into death. Wills, trusts, powers of attorney and other vehicles are available that, when appropriately used, can make this time easier on those who assist the elderly individual. Choosing the tools used may be less important than making sure there is someone who is aware of their existence. At some point some person or institution, depending upon the choices made, will need to gather all the necessary information together due to the individual’s illness or death. Although a family member or friend may not necessarily charge the estate for their services a professional person or institution most certainly will. Aside from the fees that may be charged for pulling all the information together, it just makes sense to be organized.

Many individuals, due to personal reasons, do not want family members handling their affairs during an illness or the estate upon their death. In such cases a family attorney is
often called upon to act on their behalf during these times. Of course the attorney will charge a fee and it is reasonable for him or her to do so.

When an individual divorces or remarries this is certain to affect how the estate will be settled. Any major change should be addressed through the will and possibly through some type of trust. Families sometimes resent a new spouse brought into the family since members (especially children) might worry that the new spouse will affect inheritances (and they often do).

It is impossible to recommend how such a situation should be handled since all families bring their own unique personalities to the table, but many agents recommend purchasing life insurance policies with each child being a beneficiary. To prevent unnecessary resentment, many agents further recommend that separate policies be purchased so that each child may be handed their issued policy for safe keeping. The parent need not explain their estate in these cases since each child is assured of receiving compensation for being born.

It is highly recommended that the individual consult with an estate planning attorney, one who specializes in estates rather than handling them along with all other types of law. Most attorneys probably handle estates but one who specializes in this type of law is generally preferred since their expertise will be greater than the general law practitioner. An elder care attorney may be a sound choice although he or she is not necessarily an estate expert. Elder care attorneys do bring much experience, however, in the types of law that may apply to an individual as he or she ages. Just as selecting doctors that specialize may make a difference in the type of care received; selecting proper attorneys can also make a difference.

**Necessary Steps**

Although most people will eventually end up retired, few people land *comfortably* in retirement without having done some financial planning over the years. Unfortunately too many people simply want, hope, and pray for financial security; they don’t actually take the steps necessary to achieve it. While everyone would appreciate a rich uncle leaving them a fortune or finding the winning lottery ticket, most of us will have to do the necessary planning and saving for ourselves.

Of course, retirement is not the only reason people establish savings goals. For example people may be saving for a down payment on a home or for college tuition for their children. Whatever the eventual destination happens to be, growth of funds is necessary to reach the goal. If the goal is long-term (retirement) interest accumulation is vital. While an individual could save the entire amount needed to retire, interest earnings makes that unnecessary – if the account is established early enough.
Financial planning is the ongoing development, implementation and revision of a financial goal. There is a beginning, middle, and end. Financial planning is never the products used; products are merely the instruments used to reach the final goal. Financial planning must be flexible, able to respond if the individual’s circumstances change.

A financial goal can be virtually anything from a secure retirement to purchasing a luxury item. Regardless of the actual goal, the steps taken to achieve success are basically the same:

- Identification of the goal;
- Determining the amount of money it requires;
- Setting up a plan of savings based on the length of time available;
- Selecting a vehicle to hold the savings;
- Begin saving on a regular basis.

While there are many reasons an individual fails to start saving part of their income on a regular basis, a commonly stated reason is lack of ability (“I don’t earn enough to save anything”). There is no doubt that saving money can be difficult, especially in these tough economic times. However, our parents and grandparents managed to save in worse times than these. The bigger problem is how we determine necessities. Today’s population grew up buying what they wanted immediately; there was no such thing as waiting until it was affordable. If the neighbors have it, we want it. Out comes the credit card and we go deeper in debt.

Parents want their children to have what other children have. Individuals want what the advertisers are selling. Everyone has lost the ability to stop and say “no” to additional debt. Financial analysts are predicting that for the first time in a couple of generations our children will be worse off financially than their parents. Yes, some of it has to do with the economic times, but much of it has to do with our lost ability to save money and spend sensibly. Americans generally spend more than they earn and consume more goods than they produce, becoming increasingly dependent upon the goods manufactured in other countries.

Americans have been on a national shopping spree for the last thirty years with foreigners subsidizing that spending. Other countries realized what Americans did not: if we continue to spend without saving at some point we will hit the brick wall and have no where to go but down. Meanwhile foreigners are financing more than half the Federal budget deficit and purchasing huge chunks of U.S. real estate and corporate stock. This leads to many key decisions regarding America’s economic future determined not only by politicians and businessmen in America but also by economists and businessmen in Tokyo, London, Frankfort, Amsterdam, and Toronto. As foreign concerns own greater portions of America we can expect future loans from those countries coming with strings attached, such as economists appointed from their countries. There are concerns that
borrowing from foreign countries eventually weakens our defenses against everything from terrorism to domestic crime. On the other hand, if we seem unable to curb our own personal and government spending perhaps outside influence is desirable. There are many opinions but few hard facts. One thing we do know: the government and Americans must change how they spend and save.

Although most Americans have not seen a rise in their standard of living since the 1970’s, not everyone has had stagnant incomes; between 1977 and 1990 compensation for top corporate executives rose by 220%. At the same time, their personal income taxes were cut dramatically. In 1960, the average pay for the chief executive officers of the nation's leading corporations, after taxes, was 12 times greater than the average wage for factory workers at their companies. By 1993, chief executive officer’s pay was more than 100 times greater than their average employee’s. In contrast foreign CEOs earn dramatically less and seem to have more in common with their employees. Recent events have made it obvious that higher pay does not equate into added value, as companies faced financial failures and requested bailouts from those lower paid workers through loans and tax reductions. It equates into the poor and middle class subsidizing some of the highest paid executives in the world.

Benjamin Franklin said “We promise the pursuit of happiness but it is up to the individual to catch it.” Democracy is based on the idea that each of us has an equal opportunity to become affluent through self-improvement and hard work, but we have a growing segment of our population that believes affluence is permanently beyond their reach. These people include the homeless, working poor, laid-off blue- and white-collar workers, high school dropouts, and the functionally illiterate. At one time we believed their children, through educational opportunities, would rise above the conditions their parents endured but as higher education has become increasingly expensive that dream also seems to be fading. Additionally we have college graduates unable to find meaningful employment, working at coffee houses and in department stores, struggling to pay off huge college loans. Their financial dreams may be years from fulfillment.

Jobs still exist in America, but they seem to be increasingly in the service sector (waitresses, clerks, and so forth) rather than in manufacturing and other higher paid fields. Employment in the auto and steel industries is down by more than 50% over the last two decades and continues to decrease, despite government bailout money. The midwestern industrial heartland is disappearing. We don’t want to end up a nation of fast food counter clerks. Employment should have the ability to bring job satisfaction and affluence. That is the American dream. The ability to be a stay-at-home mother has mostly disappeared as households must have two incomes just to pay all the bills.

Americans still want to believe they can spend their way to affluence but we must realize – soon – that spenders never outlast savers. Having a nice home, decent job and better life is still possible but it is harder to obtain than it used to be. For some Americans the dream of “having it all” has turned into home foreclosures, evictions, job
downsizing and the realization that credit card due dates keep coming even after the income stops. Fewer and fewer people are making it. It took the massive home foreclosures and debt failures to bring us back to financial reality, though not necessarily to financial reform.

It isn’t just spending recklessly that has harmed America’s economy. We have also failed in the educational field (including financial education) turning out high school graduates that are poor readers and lack mathematical training. We have told our citizens they don’t need to support themselves as long as we have the government to do it for them. One out of every 10 Americans is on public assistance and there is a growing permanent class of fifth-generation welfare families. Children who do not learn any other way to live have little understanding or appreciation of the rewards a job brings. Instead they continue to stand with their hands out with entitlement in their heads.

How do we break the habit of spending and sow the seeds of saving for tomorrow and into retirement? It can be very difficult to change the habits of an individual, let alone an entire nation. Recent economic conditions should certainly highlight the need to change and begin protecting ourselves financially through regular saving routines.

**Good Decision Making Requires Knowledge**

Before an agent can make meaningful recommendations, he or she must gather facts pertinent to the situation. This is done by asking questions. One might assume that the first question should pertain to the assets the client currently has but that is usually not the most important information. Questions might include the following:

- Where do you feel you are financially right now today?
- Where would you like to be financially in five and also ten years?
- What do you feel you need to have saved for retirement?
- Are you aware of the choices available to you?
- What financial vehicles are you interested in based upon what you know today?
- What have you saved up until now?
- Are you currently saving on a monthly basis?
- What do you feel you need to do to accomplish the goals you have?

The point of asking questions is not necessarily to discover the client’s assets but rather to provoke thought. If the individual has never saved a dime he or she needs to begin thinking about doing so. If the individual is saving but not enough, he or she needs to begin saving more. The goal is to get the “thinking” converted to “doing.” If the agent tells the client he or she needs to begin saving money for retirement, the client may or
may not believe the statement. If the client says they must save for retirement, he or she already believes it is true.

**Deferred Compensation Plans and Divorce**

Most of us can expect to live many years in retirement. Since we know Social Security will not provide sufficient retirement income, workers must provide retirement income for themselves. Men are more likely than women to receive a company sponsored retirement plan since men are more likely to stay with the same job for a long period of time. Women are more likely to work around their children’s needs and their husband’s career. Although this is changing, the change is coming at a time when companies are dropping their company-sponsored retirement plans as part of many cost-cutting measures.

Deferred compensation refers to traditional employer-sponsored pension plans, 401(k) plans, Individual Retirement Accounts (IRA) or any other retirement asset providing income during retirement. Regardless of which spouse earned the pension, it often becomes part of property settlement procedures during divorce. How pension plans are divided will depend on the type of asset, its value, and what the divorcing spouses each have from their jobs. Sometimes it may be an even division, but not necessarily so. One of the worst scenarios is the transfer of retirement assets to a former spouse with the original pension owner being liable for the taxes and any penalties resulting from early withdrawal.

**Types of Retirement Assets**

There are three kinds of deferred compensation plans, each having subcategories. The three types include:

1. **Saving plans**, which includes such things as IRAs, 401(k) Plans, ESOPs, and Thrift Savings Plans.

2. **Defined contribution** plans, where contributions are “defined.” The plan’s value is, therefore, determined in part by the amount of contributions made. The money contributed is typically invested in some manner chosen by the participant with the growth contributing to the final plan value. No actuarial estimates are necessary since employer contributions are determined by the plan agreement and are often a percentage of the employee’s earnings. Often the employees manage these plans rather than the employer.

3. **Defined benefit** plans, which have a “defined” monthly benefit that will be paid upon retirement, and ending only upon the death of the worker. Depending upon beneficiary designations, the monthly benefit may continue until the death of the worker’s spouse. Defined benefit plans use a formula based on the number of
years the worker is employed by the company. The employee is entitled to mandatory employer contributions, interest, and a specified benefit at some predetermined time period (defined as retirement age). Defined benefit plans were the most common at one time, but they have lost favor with employers due to their high cost.

**Saving plans** (such as IRAs) are considered *cash plans* because they may be liquidated prior to retirement age, although there may be penalties and/or taxes that are due upon withdrawal. Although cash plans are usually the easiest to divide in a divorce, before any division may be made the custodian of the account must receive and review a certified copy of the court order requiring division. The non-employee spouse must fill out documents requesting their preferred manner of payout. IRA proceeds may be cashed out and paid directly to the receiving spouse or they may be "rolled" over into a new IRA in the receiving spouse’s name. If the IRA or other savings plan is simply cashed out prior to age 59½ there may be tax and early withdrawal consequences that could reduce the plan proceeds by more than 30%. It must be decided in the divorce proceedings which party will pay taxes and penalties on early withdrawals. Often the party’s lawyers will recommend waiting to withdraw funds until retirement age to maximize values.

**Defined Contribution Plan** values will be based in part on its vesting status. The valuation may generally be determined by multiplying the account balance by the percentage of vesting. While this method may not be exactly accurate, it will give a general value for purposes of the divorce. Defined contribution plans generally can be divided in the divorce with each party receiving half of the current vested value.

**Defined Benefit Plan** values generally cannot be liquidated prior to retirement age. The non-participating spouse may receive a retirement plan in his or her name for his or her marital interest in the participant's plan. Generally the spouse’s half is subject to the same terms and conditions as the original plan, which is why it cannot be liquidated in most cases. Upon retirement the plan participant (worker) may typically choose a payment method from several available options. Most people choose a monthly income lasting throughout their retirement years. The chosen method will affect the amount or timing of the payments to both the participant and any receiving spouse. This may mean that retirement benefits are received when the original participant decides to retire, not when the recipient spouse retires.

Generally a defined *benefit* plan may be divided in one of two ways.

1. **Cashing Out:** The worker may elect to receive the money in the retirement plan outright, cashing out his or her interest. The *present value* must be determined when cashing out the plan. "Present Value" is the current value of the worker’s future benefit. Today’s defined benefit dollar is going to be worth more at retirement because it will have accrued interest between today and retirement. Therefore, benefits that would have been received at retirement age would have a
lower value today if paid in a lump sum. Typically the present value is
determined by an actuary or qualified accountant. Even when the divorce
attorneys do not require this, it may still be necessary since value determination is
often complicated.

2. **Division of Future Benefits**: Rather than cashing out the current value, a defined
benefit plan may be divided by dividing the future stream of retirement income,
which is often more beneficial to the divorcing spouse. This is accomplished
through a Qualified Domestic Relations Order (QDRO), which is a court order
instructing the pension plan to pay an Alternate Payee (the former spouse) a
portion of retirement benefits accrued by the plan participant. Under this method
the court retains jurisdiction until benefits are paid.

**457 Deferred Compensation Plan**

A 457 Deferred Compensation Plan is a supplemental retirement savings program that
allows the participant to make contributions on a pre-tax basis. Federal and usually state
income taxes are deferred until assets are withdrawn. This usually happens at retirement
when the participant is likely to be in a lower tax bracket.

There are specific benefits to participating in a 457 plan:

1. The participant reduces current income taxes while investing for his or her
retirement.

2. The participant’s earnings accumulate tax-deferred; taxes will be due upon
withdrawal.

3. Participants may dollar-cost-average through convenient payroll deductions. It is
important to note that dollar cost averaging does not assure profit nor protect
against loss in a declining market. Since dollar cost averaging involves
continuous investing, regardless of fluctuating prices, investors must consider
their comfort level when continuing to invest during a declining market.

4. The participant may be allowed to make additional "catch-up" contributions if he
or she is at least age 50 or within three years of normal retirement age and already
contributing the maximum to his or her plan.

If the participant changes jobs he or she will have the flexibility to move the account into
the new employer's retirement plan. If the new employer does not have a retirement plan
the worker may make other changes necessary to preserve the retirement funds. If the
participant retires or leaves service early, there is no penalty for withdrawals.
There are many ways to save money. An individual can put their money in a sock under their mattress or bury coffee cans full of dollar bills in the back yard. Of course, that is not the method recommended!

Any type of savings is better than none. However, the best way to save is to seek not only interest gains but also tax advantages when available. Americans have many valuable tools available, including Roth and traditional IRAs (Individual Retirement Accounts), Keogh plans in some cases, perhaps 401(k) plans, and some types of deferred compensation plans.

IRAs are legal due to the IRCs

The individual retirement arrangement and related vehicles were created by amendments to the Internal Revenue Code of 1954 (as amended) made by the Employee Retirement Income Security Act of 1974 (ERISA), which enacted (among other things) Internal Revenue Code sections 219 (26 U.S.C. § 219) and 408 (26 U.S.C. § 408) relating to IRAs. IRA’s were specifically created, however, by the Tax Reform Act (TRA) of 1986 (Pub.L. 99-514, 100 Stat.2085).

IRA Choices

There are a number of different types of IRAs, which may be either employer-provided or self-provided plans. The types include:

- **Roth IRA**: Roth contributions are made with after-tax assets. The Roth IRA has no tax impact for the year of contribution or while held in the account, but withdrawals are usually tax-free since the amount deposited was already taxed prior to deposit. The Roth IRA is named for Senator William Roth.

- **Traditional IRA**: Traditional IRA contributions are usually tax-deductible in the year of contribution. All transactions and earnings within the IRA have no tax impact since traditional IRAs are tax sheltered; earnings are not taxed until
withdrawn. At retirement withdrawals are taxed as income, except for those portions of the withdrawal corresponding to contributions that were not deducted. Depending upon the nature of the contribution, a traditional IRA may be referred to as a "deductible IRA" or a "non-deductible IRA."

- **SEP IRA:** SEP stands for *Simplified Employee Pension*. The SEP IRA allows an employer (usually a small business or self-employed individual) to make retirement plan contributions into a Traditional IRA established in the employee's name. It is the small company’s version of a pension fund.

- **SIMPLE IRA:** This is a simplified employee pension plan that allows both employer and employee to make contributions, similar to a 401(k) plan, but with lower contribution limits and simpler, less costly administration. Although it is termed an IRA, it is treated separately and is a type of SEP.

- **Self-Directed IRA:** The self-directed IRA permits the account holder to make investments on behalf of their retirement plan.

The Roth IRA was established by the Taxpayer Relief Act of 1997 (Public Law 105-34). A Roth IRA may usually invest in a variety of vehicles, including securities, annuities, common stocks and mutual funds. As with all IRAs, there are specific eligibility and filing status requirements mandated by the IRS. The tax structure of the Roth IRA is its most quoted advantage.

The total contributions allowed per year to all IRAs combined is limited to a specific dollar amount. The total amount deposited within any one tax year may be split up between multiple traditional and Roth IRAs (first allowed in 1998) but the total of all combined contributions may not exceed required limitations for that year. In the case of a married couple, the following history shows what each spouse may have contributed:

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<th>Year Range</th>
<th>Age 49 or Less</th>
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<tr>
<td>2008-2009 *</td>
<td>$5,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

*Starting in 2009, contribution limits were assessed for a potential increase (in $500 increments) based on inflation.

**Tax Free Retirement**

Roth IRAs, which appeared in 1998, began a new way of saving for retirement – with non-taxable income. Prior to Roth IRA’s savers primarily had two choices:
Dollars and Sense
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- Put investment funds into a regular taxable mutual fund or brokerage account, paying taxes on the investment income each year, and with tax liability when the shares were sold after their value had risen.

- Or, the investor could set money aside in special tax-deferred accounts, including annuities through insurance companies. Traditional IRAs gave the investor flexibility, but they had low contribution limits (just $1,500 per year when IRAs were first created). Even though the limits are higher now for IRAs with contribution levels best for those over age 50 or nearing retirement, there are still caps. Employee 401(k) plans, on the other hand, have much higher annual contribution limits but the investor typically is confined to whatever investment choices their employer provides. Both of these options keep the investor from paying tax on the income they have earned until funds are taken out of the account, potentially giving the investor decades before he or she must pay tax on the earned income.

The Roth IRA takes taxes out of the equation entirely since funds are taxed prior to being deposited. Unlike traditional IRAs and 401(k) plans, the investor does not receive any sort of up-front tax break for making contributions to their Roth IRA. The investor never has to pay income tax on the income from their Roth investments even when withdrawn.

An individual can invest in a Roth IRA in two ways: by making an annual contribution or by converting an existing traditional IRA or 401(k) account, if earnings allow it. Individuals should consult with their tax accountant for details.

There may be a disadvantage to converting to a Roth IRA: income taxes on the amount converted must be paid. Some may question paying taxes that otherwise would not be due until later in life, but there are a couple of reasons why converting to a Roth might be advisable. Taxes could go up in the future so paying taxes today with today’s dollars might be a smart thing to do for some investors. New taxes on investments could rise at some point. If the investor is eligible for a low rate currently, it might be cheaper in the long run to give up tax deferral and pay the tax now. If portfolio values happen to be down, the investor is likely to pay fewer taxes than when they are up, so this should also be considered.

In most tax matters, it is wise to speak with a professional to make sure adding more income doesn't have unintended consequences. An agent should never offer tax advice unless he or she has the background or education to do so.

One of the smartest money moves a young worker can make is to invest in either a Traditional or Roth IRA. For many investors, the Roth IRA works well. Investing small amounts early in life prevent the necessity of investing larger amounts later in life, often
just prior to retiring. An IRA is more flexible than a 401(k) and many other retirement plans due to the IRA’s ability to invest in a variety of financial vehicles.

Those who are new to the work force often feel they have more important places to put their earnings, but saving just a few dollars out of every paycheck can provide large returns through time and interest earnings. Whether a Traditional IRA or Roth IRA is chosen, the benefits will be much greater than waiting until age forty or fifty to begin retirement savings (as the majority of people do).

While there are many vehicles for retirement savings an IRA is one of the best. A 25-year-old who saves $5,000 every year in a tax advantaged plan until he or she retires, making an average annual return of 8% on the investment, will have accumulated $1.4 million by age 65.

Whatever vehicle is used to save for retirement, the important thing is saving something so there will be assets available. This begins with setting a realistic goal, creating a plan to achieve the goal, and sticking with the plan even when it seems difficult to save and more desirable to spend.

**Differences Between the Roth and Traditional IRA**

Unlike traditional IRAs, contributions to Roth IRAs are not tax-deductible. Withdrawals are usually tax-free, but there are certain stipulations, including at least a five year “seasoning period” for principal withdrawals. The owner's age must be at least 59½ for withdrawals on the growth portion above principal. The Roth IRA has fewer withdrawal restrictions than a traditional IRA since taxes were already paid on the principal deposits. Transactions inside the Roth IRA account (such as capital gains, dividends, and interest) do not incur a current tax liability.

As with all things, there are both advantages and disadvantages with the Roth IRA. **Roth advantages include:**

- Direct contributions to a Roth IRA may usually be withdrawn tax free at any time. Rollover or converted contributions prior to age 59½ held in a Roth IRA may be withdrawn tax and penalty free after the five year seasoning period. Earnings may be withdrawn tax and penalty free after the seasoning period or after age 59½ or other qualifying event. Traditional IRAs are taxed as ordinary income and include a penalty for withdrawals made prior to age 59½. In contrast, stocks or mutual funds held in a regular taxable account for at least a year would be taxed at the lower long-term capital gains rate. This higher tax rate for withdrawals from a traditional IRA is a quid pro quo for the deduction taken against ordinary income when putting money into the IRA.
• If money has been converted to a Roth IRA from a traditional IRA, the Roth IRA owner may withdraw up to the total of the converted amount without penalty, as long as the "seasoning" period has passed on the converted funds.

• Direct contributions to a Roth IRA (not including rollovers) may be withdrawn at any time with no tax or penalty since they have already been taxed.

• Up to $10,000 in earning withdrawals are considered qualified (tax-free) if the money is used to acquire a principal residence. This house must be acquired by the Roth IRA owner, their spouse, or their lineal ancestors and descendants. The owner or qualified relative who receives such a distribution must not have owned a home in the previous two years.

• Contributions may be made to a Roth IRA even if the owner participates in a qualified retirement plan, such as a 401(k). Contributions may also be made to a traditional IRA in this circumstance, but they may not be tax deductible.

• When spouses both own Roth IRAs and one of them dies naming the other as sole beneficiary of their Roth IRA, the two Roth IRAs may be combined into a single account without penalty.

• Since Roth IRAs are taxable at the time of deposit (traditional IRAs usually receive a tax deduction upon deposit) owners who anticipate a higher tax rate in retirement than during their working years will benefit from a Roth IRA since funds from Roth IRA’s are not taxed upon withdrawal. There is no current tax deduction for Roth deposits; money going into the Roth IRA is taxed at the taxpayer's current marginal tax rate. They avoid taxation at any anticipated higher future effective tax rate upon withdrawal.

• The Roth IRA does not require distributions based on age. Other tax-deferred retirement plans, including the related Roth 401(k), require withdrawals to begin by April 1 of the calendar year after the owner reaches age 70½. An individual who does not need the money may leave it on deposit in the Roth IRA for their heirs, allowing it to continue accumulating income tax free. Beneficiaries will be subject to the minimum distribution rules.

• Whether or not Roth contributions are more beneficial than traditional IRA deposits often depend upon the tax rate applied in retirement. Roth contributions have already been taxed so it may be equivalent to a larger contribution than a traditional IRA that will be taxed upon withdrawal. For example, a contribution of $5,000 to a Roth IRA in 2009 may be equivalent to a traditional IRA contribution of $6,667 (assuming a 25% tax bracket at both contribution and withdrawal). It was not possible to contribute $6667 to a traditional IRA due to contribution limits, so the post-tax Roth contribution may be larger. However, many people end up in a lower tax bracket in retirement, so they may not realize as much of this benefit. Even so, regardless of whether marginal tax rates
increase or decrease in retirement, Roth IRA earnings are not taxed which is often a benefit for the Roth IRA owner.

Roth IRA disadvantages include:

- Roth IRA deposits are not tax deductible for the year of contribution. By contrast, contributions to a traditional IRA are tax deductible (within income limits). Therefore, someone who contributes to a traditional IRA instead of a Roth IRA receives an immediate tax savings equal to the amount of the contribution multiplied by their marginal tax rate; an individual who contributes to a Roth IRA does not realize this immediate tax reduction. Also, by contrast, contributions to most employer sponsored retirement plans (such as a 401(k), 403(b), SIMPLE IRA or SEP IRA) are tax deductible with no income limits because they reduce a taxpayer's adjusted gross income.

- Eligibility to contribute to a Roth IRA phases out at certain income limits. By contrast, contributions to most tax deductible employer-sponsored retirement plans have no income limitations.

- Contributions to a Roth IRA do not reduce a taxpayer's adjusted gross income (AGI). Contributions to a traditional IRA or most employer-sponsored retirement plans will reduce the taxpayer's AGI. One of the key benefits of reducing one's AGI (aside from the obvious benefit of reducing taxable income) is that a taxpayer who is close to the threshold income of qualifying for some tax credits or tax deductions may be able to reduce their AGI below the threshold at which he or she may become eligible to claim certain tax credits or tax deductions that may otherwise be phased out at the higher AGI had the taxpayer instead contributed to a Roth IRA. Likewise, the amount of those tax credits or tax deductions may be increased as the taxpayer slides down the phaseout scale. Examples include the child tax credit, the earned income credit, and the student loan interest deduction.

- A taxpayer who chooses to make a Roth IRA contribution while in a moderate or high tax bracket will likely pay more income taxes on the earnings used to make the Roth IRA contribution as compared to a traditional IRA contribution. A contribution to a traditional IRA or employer-sponsored tax deductible retirement plan results in an immediate tax savings equal to the taxpayer's current marginal tax bracket multiplied by the amount of the contribution. Many people have less income in retirement than during their working years, and thus end up in a lower tax bracket during retirement. Even though taxes are due when funds are withdrawn from a traditional IRA the rate of taxation is low enough that the Roth IRA might not have ended up being an advantage over the traditional IRA. The higher the taxpayer's marginal tax rate, the greater the disadvantage.

- A taxpayer who pays state income taxes and contributes to a Roth IRA (instead of a traditional IRA) will have to pay state income taxes on the amount contributed to the Roth IRA in the year the money was earned. If he or she retires to a state
with a lower income tax rate, or no income taxes, any Roth IRA benefit related to the state taxes will be lost. He or she might have done better with a traditional IRA since no state taxes were avoided.

- Of course, there is no way to know if the contributor will live until retirement age. The perceived Roth IRA tax benefit may never be realized if he or she dies prior to retirement or soon thereafter. The tax structure of a Roth only serves to reduce the estate, which may not have been subject to much tax anyway. An individual must live until the Roth IRA contributions have been fully withdrawn to fully realize all tax benefits. With a traditional IRA, tax might never be collected at all if the owner dies prior to retirement with an estate below the tax threshold, or goes into retirement with income below the tax threshold (to benefit from this exemption, a beneficiary must be named in the appropriate IRA beneficiary form). The estate tax exemption will not apply to beneficiaries inheriting the IRA solely through a will. Additionally, beneficiaries will be subject to income taxes unless the inheritance is a Roth IRA. Heirs will have to pay taxes on withdrawals from traditional IRA accounts and must continue to take mandatory distributions although they will now be based on the beneficiary’s life expectancy rather than the deceased contributor’s. Additionally it is always possible that tax laws could change by the time one reaches retirement age.

- Congress may change the rules that currently allow for tax free withdrawal of Roth IRA contributions. Therefore, someone who contributes to a traditional IRA is guaranteed to realize an immediate tax benefit, whereas someone who contributes to a Roth IRA must wait for a number of years before realizing the tax benefit, and that person assumes the risk that the rules will be changed during the interim.

**Double Taxation**

Double taxation could occur within some tax sheltered investment accounts. For example, foreign dividends may be taxed at their point of origin, and the IRS does not recognize this tax as a creditable deduction. There is some controversy over whether this violates existing joint tax treaties, such as the Convention between Canada and the United States of America as they apply to taxes on income and capital.

Canadians who have a U.S. issued Roth IRA will be affected by a new rule in 2008 which states that Roth IRAs (as defined in section 408A of the U.S. Internal Revenue Code) and similar plans are considered to be pensions. Therefore distributions from a Roth IRA (as well as other similar plans) to a Canadian resident will generally be exempt from Canadian tax to the extent that they would have been exempt from U.S. tax if paid to a resident of the United States. Canadian residents may elect to defer any taxation in Canada with respect to income accrued in a Roth IRA, but not distributed, until and to the extent that a distribution is made from their Roth IRA.
Individuals making contributions to Roth IRAs while they are Canadian residents (other than rollover contributions from another Roth IRA) will lose the IRA’s status as a pension for purposes of the Treaty with respect to the accretions from the time such contribution are made. Income by growth or additions is subject to Canadian tax laws. In effect, the Roth IRA will be divided into two sections: a "frozen" pension that will continue to enjoy the benefits of the exemption for pensions and a non-pension (essentially a savings account) that will not.

**Roth IRA Eligibility**

Congress has limited who can contribute to a Roth IRA based upon income. A taxpayer can only contribute the maximum amount if their modified adjusted gross income (MAGI) is below a specified level. Once the modified adjusted gross income hits the top of the range no contribution is allowed. Excess Roth IRA contributions may be recharacterized into Traditional IRA contributions as long as the combined contributions for all individual retirement accounts combined do not exceed that tax year's limit.

Once a Roth IRA is established the balance in the account remains tax-sheltered, even if the taxpayer's income rises above the threshold at a later date. The thresholds are for annual contribution eligibility to contribute, not for eligibility to maintain the Roth account.

**Conversion Limits**

There are established income levels that must be met in the year of contribution before converting from a Traditional to Roth IRA. The contributor should consult with his or her tax advisor for current MAGI limitations. TIPRA 2005 eliminates the MAGI limit and filing status restrictions on conversions beginning in the year 2010. Therefore, regardless of income, contributions could be made to a traditional IRA in previous years, and then rolled over in 2010.

Every type of financial vehicle, as we have said, has both advantages and disadvantages. Here are some advantages of the Traditional IRA:

- A primary advantage of a Traditional IRA rather than a Roth IRA is the tax deductibility in the contribution year. For example, a person who is in the marginal tax bracket of 25 percent and contributes $4,000 to a Traditional IRA will see a benefit of about $1,000 for the tax year, meaning they will pay around $1,000 less in taxes. It is possible to contribute more than the $4,000 in our example. Because qualified withdrawals are taxed as ordinary income (the taxpayer's highest rate) the long-term benefits of the Traditional IRA are only
comparable to those of a Roth IRA (whose qualified distributions are tax free) if the current year tax benefit of $1,000 is reinvested.

- If a taxpayer expects to be in a lower tax bracket in retirement than during their working years, then a traditional IRA offers an increased incentive over the Roth IRA.

- With the Traditional IRA the taxpayer gets the tax benefit in the immediate tax year; he or she does not have to wait until withdrawals are made to realize a tax advantage.

- As previously stated, there may be some risk that Congress will change the current tax status of Roth IRAs, removing their tax-free distributions. Some feel the Democrats do not fully support giving the distribution tax advantage found in Roth IRAs. If their perception is correct it is possible this benefit could be retracted on new contributions; existing contributions are not likely to be affected.

**Traditional IRA disadvantages include:**

- Traditional IRAs have eligibility requirements for their tax-deductibility. If an individual is eligible for a retirement plan at work, his or her income must be below a specific threshold for filing status.

- All withdrawals from a Traditional IRA are included in gross income and subject to federal income tax except for any nondeductible contributions; there is a formula for determining how much of a withdrawal is not subject to tax. Traditional IRAs are not attractive to everyone, especially if their investment style is buy-and-hold or dividend-seeking. Holding stocks in an IRA means the investor may lose any favorable tax treatment given to dividends and capital gains.

- For individuals with lots of disposable income, a Roth IRA in effect shelters more assets from taxes on gains than a Traditional IRA does. Suppose an individual is eligible to contribute either to a Roth IRA or a Traditional IRA. If the investor chooses the Traditional IRA, then he or she receives an upfront tax deduction. When the money is withdrawn from the Traditional IRA it will be taxed at marginal rates. On the other hand, if the investor chooses the Roth IRA then there is no upfront tax deduction, but the money and gains are all exempt from taxation upon withdrawal in retirement. For the Traditional IRA to outdo the Roth IRA the investor must be in a lower tax bracket in retirement than in their contribution year. If he or she is in a lower tax bracket the Traditional IRA becomes an advantage rather than a disadvantage.

- Perhaps the greatest disadvantage of the Traditional IRA is its forced distributions based on age. Withdrawals must begin at age 70½ (more precisely, April 1 of the calendar year after age 70½ is reached) based on a
complicated formula. If an investor fails to make the required withdrawal, half of the mandatory amount will be confiscated automatically by the IRS. The Roth is completely free of these mandates because no taxes will be owed so the IRS realizes no financial gains when funds are withdrawn.

- In addition to the distribution being included as taxable income, the IRS will also assess a 10% early withdrawal penalty if the investor is under age 59½ when funds are withdrawn. The IRS will waive this penalty under some conditions, including a first time home purchase (up to $10,000), higher education expenses, death, disability, unreimbursed medical expenses, health insurance, annuity payments and payments of IRS levies, all of which must meet certain stipulations.

Transfers Versus Rollovers

Transfers and rollovers are two ways of moving IRA sheltered assets between financial institutions.

A transfer is normally initiated by the institution receiving the funds. A request is sent to the disbursing institution for a transfer and a check (made payable to the other institution) is sent in return. This transaction is not reported to the IRS because the transfer is not considered a withdrawal.

A rollover (sometimes called a 60-day rollover) is another way to move IRA money between institutions. The institution holding the IRA funds distributes funds by check payable directly to the participant. The participant has 60 days to make a rollover contribution to another financial institution and still retain IRA status (avoiding penalties and taxation). This type of transaction can only be done once every 12 months with the same funds. Unlike the transfer, a rollover is reported to the IRS by the distributing institution. Once the distribution is rolled into an IRA, the participant will be sent a Form 5498 to report on their taxes to nullify any tax consequence of the initial distribution.

IRA Loans

IRA loans are prohibited. Prohibiting loans allows IRS to disqualify the plan if a loan is made and then tax the assets. Some individuals utilize “creative banking” by withdrawing funds from their IRA and redepositing them within the 60-day rollover period. This maintains the IRA status and avoids taxation as long as the participant redeposits within that 60-day time period. One 60-day rollover is allowed every rolling 12 months, per allocation of funds within the IRA. For example, if the participant has $100,000 in his or her IRA he or she may withdraw $10,000 with 60 days to return it to the same or different IRA. After returning the first $10,000, he or she could then
withdraw another (supposedly different) $10,000 and repeat the process. Assuming each rollover is in $10,000 increments from the $100,000 account, the participant could repeat this process 10 times within a single year. If the participant rolled the entire $100,000 account within 60 days, he or she would have to wait another year before repeating the process.

Coveradell Education Savings Account

The Coveradell Education Savings Account was formerly known as the Educational IRA.

Starting with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), many of the IRA restrictions were significantly relaxed. Other legal changes continued to ease restrictions. Many retirement plans can be rolled into an IRA after meeting certain criteria, and most retirement plans can accept funds from an IRA. Not all types of plans can be rolled into an IRA however. A non-governmental 457 plan cannot be rolled into anything but another non-governmental 457 plan, for example.

Except for the Roth IRA, the tax treatment of retirement funds is substantially similar regarding fund distributions. SEP IRAs and SIMPLE IRAs do have additional rules similar to those for qualified plans governing how contributions can and must be made and which employees are qualified to participate.

IRA Funding Limitations Exist

Individual Retirement Accounts have contribution limits; it is not possible to invest as much as one wishes to.

- IRAs can only be funded with cash or cash equivalents. It is not possible to fund an IRA with any other type of asset. Attempting to do so would be a prohibited transaction and would result in the loss of the IRA’s beneficial tax treatment.

- Rollovers, transfers, and conversions between IRAs and other retirement accounts can include any qualified asset.

- There are maximum contribution amounts for IRAs. All contributions must come from earned income.

- The contribution limit applies to the sum of all IRAs combined. The investor may not put the maximum amount into a Roth IRA, for example, plus another maximum amount into a traditional IRA; the total amount contributed may not exceed the limitation.
IRA Investments

Some IRAs allow the account owner to direct how their IRA money is invested. The IRA owner may direct the custodian to use the cash to purchase most types of securities, for example, as well as some non-security financial instruments. Some types of assets obviously would not work in an IRA, including art or rare coins. Cash value life insurance may not be included in IRAs either, even though the cash may already exist in the policies. IRAs cannot own real estate if the IRA owner receives any immediate gain from the real estate investment. For example, the investor’s personal residence cannot be fund an IRA. Any property that provides the investor with personal compensation for management duties or other services or adds capital value to the property may not fund the Individual Retirement Account. IRA custodians may have additional restrictions. Custodians may legally impose their own restrictions above and beyond the rules imposed by the IRS. Custodians cannot provide legal or investing advice; they merely carry out their established custodial duties.

Most IRA custodians limit available investments to traditional brokerage accounts such as stocks, bonds, and mutual funds, and do not permit real estate in the IRA unless it is held indirectly in such things as a real estate investment trust (REIT). IRA custodians or administrators may allow real estate and other non-traditional assets in some cases, but investors should not automatically assume this. Self-Directed IRAs allowing non-security investments are more complicated. Some investments may require special expertise to properly set up. Not all custodians or administrators will have this ability.

The IRA owner may not pledge his or her IRA as security against personal debt.

Fund Distributions

Although funds may be distributed from an IRA at any time, penalties will occur if distributions are made prior to age 59½. Once the investor becomes age 59½ money can typically be withdrawn penalty free as taxable income from a non-Roth IRA (Roth IRA distributions are not taxable) once the account owner reaches age 59½. Also, non-Roth account owners (investors) must begin taking distributions from their IRA of at least the calculated minimum amounts by April 1st following their 70th birthday. Otherwise there will be a penalty of 50% of the amount that should have been withdrawn. The IRS provides a table to calculate the appropriate withdrawal amount. It is based on the life expectancy of the investor and, if applicable, their spouse’s life expectancy as beneficiary. Upon the death of the account owner distributions must continue. If there is a designated beneficiary distributions may be based on the life expectancy of the beneficiary rather than the investor.
There are several exceptions regarding distribution penalties on withdrawals prior to age 59½. Each exception has detailed rules that must be followed to escape early distribution penalties. The exceptions that may include distribution of IRA funds prior to age 59½ include:

- Unreimbursed medical expenses that are more than 7.5% of adjusted gross income (AGI) might allow IRA funds to be withdrawn and used to pay these bills.
- Distributions for medical insurance premiums while unemployed, as long as they are not more than the actual cost. In other words, all the IRS funds withdrawn must apply only to the premium amount.
- Disability (defined as not being able to engage in any substantial gainful activity).
- Amounts distributed to beneficiaries of the deceased IRA owner.
- Distributions in the form of an annuity.
- Distributions for qualified higher education expenses for the IRA investor, their children, or grandchildren as long as the distributions do not exceed the actual cost of schooling.
- Distributions to buy, build, or rebuild a first home ($10,000 lifetime maximum) and
- A forced distribution due to an IRS levy on the plan.

Roth IRA owners may withdraw contributed funds prior to age 59½ since no taxes will be due upon withdrawal (taxes were previously paid). There will also be no penalties for early withdrawal from a Roth IRA with funds withdrawn on a first-in, first-out basis. A penalty could apply on any growth (the taxable amount) withdrawn prior to age 59½ if an exception did not apply. Amounts moved from a traditional IRA to a Roth IRA must stay in the account for a minimum of 5 years to avoid penalties on withdrawn funds prior to age 59½ unless one of the above exceptions applies.

If the contribution to the IRA was nondeductible or the IRA investor chose not to claim a deduction for their contribution, distributions from such funds are tax and penalty free.

Bankruptcy

Individual Retirement Accounts may be exempted from the bankruptcy estate, as ruled by the U.S. Supreme Court on April 4, 2005. This is due to the fact that unpenalized withdrawals are based on age rather than financial need. Therefore, IRAs have the same legal protection as other retirement plans. Laws do vary from state to state so it is always important to know your state’s laws. The Supreme Court ruling is a federal protection, but the majority of states also have IRA protections in place. This ruling includes both
Traditional and Roth IRAs. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provided additional protection for IRAs, saying up to $1,000,000 in IRA assets could be exempt from any bankruptcy estate. The 2005 Act also increased the FDIC insurance limit on IRA deposits at banks.

**Creditor Protection**

Many states prohibit seizure of IRA assets through legal judgments. Laws will vary from state to state so, again, it is important to know the laws of one’s own state. Creditor protection would not apply in the case of divorce, failure to pay taxes, deeds of trust, or fraud. Only funds deposited in the IRA prior to the lawsuit being filed would be protected. It would not be possible to deposit funds into an IRA in order to protect them from an existing legally executed lawsuit or judgment.
Life Insurance

Life insurance is a contract between the insurer and the insured to provide benefits for another named party if the insured individual dies while the contract is active. Obviously no benefits would be paid if the contract had lapsed due to nonpayment of premiums. Life insurance proceeds are paid outside of probate proceedings so there is no delay in receiving the funds — an important point since families often need cash immediately. The existence of the policy and proceeds will be included in the probate proceedings, however. Federal and state governments may not necessarily tax the proceeds but never think they don’t want to know of their existence.

Most professionals in the finance fields agree that life insurance is necessary for the majority of people. Even so, not everyone needs to buy life insurance. In most cases, the goal is financial protection for the named beneficiaries, often spouses and children. Others may also need life insurance protection; even business associates realize they need to protect themselves from the death of a key person in their office.

If no life insurance is currently in place the first question is simple: “Do I need to purchase life insurance protection?” To answer that question, another question becomes necessary: “Would another individual suffer financially if I died?”

If no other individual would suffer a financial loss, then the conversation ends there. No other questions need be asked since there is no financial need for purchasing life insurance. Desiring insurance is not the same as needing insurance. Some people still purchase life insurance simply because they want it. Perhaps the named beneficiary will be the local homeless shelter, an animal rescue group, or Great Aunt Mary. Although all three might appreciate receiving life insurance proceeds, they don’t need the proceeds to meet their bills and continue the same lifestyle enjoyed while the insured was living. In other words, the local homeless shelter might have many financial needs (and receiving the proceeds would certainly help them meet their goals), but the insured has no moral or financial responsibility to name them as beneficiary. Desiring life insurance proceeds does not automatically mean there is a responsibility to provide benefits.

If there is someone the insured is responsible for, such as children or even aging parents, a life insurance policy is often the most logical avenue. It might be possible to save
enough money to take care of another without life insurance proceeds, but most people are not able to accumulate enough savings to meet this goal.

The amount of life insurance one should purchase depends upon several factors, including current income and lifestyle, the length of time the benefits must cover the listed beneficiaries, and personal choice. For example, a disabled child probably needs to be taken care of for his or her lifetime whereas a spouse may only need benefits to cover living expenses while attending college or vocational schooling, enabling him or her to then earn their own way in life. Generally speaking, it is better to leave the beneficiary too much money than not enough so most professionals recommend providing more than may actually be necessary by today’s standards. By the time the insured dies, what appeared to be excessive at the time of purchase may not be at the time of death due to inflation or changes in lifestyle. Of course, this is also a valid reason to reassess the amount of life insurance one carries periodically.

Policy Provisions

Although policies are not exactly the same in wording, they all contain the same basic provisions, many of which are mandated by the state of issue. The provisions contained in life insurance policies are called **general policy provisions**. Cash value policy provisions are likely to include nonforfeiture options, dividend options, and settlement options. The policy’s first page will include the insuring agreement between the policyowner and the insurance company, the beneficiaries’ names, a statement that provisions attached are part of the contract, and the amount of the periodic premium payment. Following those, there will be two types of general policy provisions: *required* and *permissible*.

When an individual buys an insurance policy, he or she always makes various decisions regarding the purchase they are making. Such decisions will relate to beneficiary designations, ownership, and policy options. Agents help their clients make appropriate decisions, basing that help on meeting the insured’s needs and goals (never the agent’s needs). Product suitability must always be a priority.

Defining the Contract

A contract of insurance is a legal contract establishing the rights and duties of the insurer and the policyowner. The policy is a complete document, but references may be made to statutes and court decisions to make its interpretation complete.

There is no short definition for insurance contracts that is *complete and accurate* although virtually all insurance manuals and educational courses provide one. Generally, insurance is defined as a financial arrangement where one party agrees to compensate
another if a covered loss occurs. While that is accurate, it is not complete. Many agreements would meet this definition even though they are not an insurance contract, for example. It is necessary to make note of the differences between insurance and noninsurance in contracts because the distinction is very important. Insurance transactions and their contracts are among the most regulated of all industries. Contracts and companies that are not insurers do not have to adhere to the regulation that insurers must. The rights of the involved parties in an insurance contract are determined by common law and statutes peculiar to insurance. Corporations could have a contract that meets the above definition even though they would operate under charters rather than insurance law.

Consumers complain that their insurance contracts are difficult to read and understand. Even agents have voiced this complaint, but the situation is unlikely to change since insurance is not a simple profession. Besides the tremendous amount of regulations involved, the contract must be able to stand up in courts and operate as they were intended to.

**Policy Application**

Policies have two basic instruments: the application and the binder. The function of the agent is to solicit prospects for insurance coverage. For life insurance agents that typically means going to the applicant’s home for a face-to-face meeting. In some cases, such as property and casualty insurance contracts, the applicant might come to the agent’s office. Today the agent may also be a voice on the telephone as more and more insurance business is completed from long distances. The internet has opened up a new way for agents to conduct business with several insurance companies and brokerages operating primarily by telephone and internet. Agents were accustomed to competition from other agents, but the competition they are experiencing from internet based companies has left many wondering if they will survive. The truth is simple: if the agent is not competent at his or her job and continuous in their client contact they may well lose business to these entities.

Agents have many roles. The first role is solicitation of business. In many cases the agent must find a company willing to accept the risk imposed by the client. Most types of insurance, including life insurance, will have specific application forms that must be used. A written application states the kind and amount of insurance requested and asks specific underwriting questions of the applicant. Initially these preprinted forms were used primarily for underwriting but after the terrorist attack of September 11, 2001 many of the forms also reflect questions relating to applicant identity. It is known that life insurance products are used in money laundering activities. While insurers may not be able to identify specifically when their products are used for such activities by verifying identities of the applicants, it does allow the federal government to track them.
The insurance contract is considered to be a contract of adhesion. The insurance agreement is prepared by the insurer’s attorneys in cooperation with state regulatory authorities. It is then offered to applicants on a take-it-or-leave-it basis. The applicant is not able to bargain price or benefits; both are set by the insurer offering the contract.

**Policy Ownership**

In most cases the policy is owned by the insured but that is not always true. It is possible for another person to own the policy or even an entity, such as a business. Life insurance proceeds are included in the taxable estate when the insured owns the policy. The same is true if the “estate” is the named beneficiary regardless of who owns the policy. If the life insurance policy is part of estate planning, the owner should be someone other than the insured. When the owner is someone other than the insured, a successor owner should be named in case the insured survives the owner. When the beneficiary is the spouse it is not necessary to have someone else as owner since the Economic Recovery Tax Act of 1981 (ERTA) eliminated the necessity for spouses to have cross ownership of the life insurance on their lives. ERTA excludes property transferred from the deceased spouse to the surviving spouse from death taxes. Even so, if the values of the combined estates (husband and wife) are high it might still be advisable to have another, such as a child, named as the policy owner to save death taxes when the surviving spouse dies.

**Preventing Money Laundering Activities**

Insurers and agents have always had responsibilities regarding the processing of policy applications. They now have additional responsibilities related to anti-money laundering. This will be a new frontier for the majority of those associated with the life insurance industry.

The insurance sector, including insurers, reinsurance companies, and their intermediaries (agents and brokers), face the potential risk of having their products misused by criminals and terrorist groups. Criminals look for ways of concealing the origins of illegitimate funds since knowledge of their illegal activities would bring about legal consequences. Those involved in terrorist activities look for ways to finance their acts of violence while concealing their intent. Cash value products, such as universal life products and annuities, provide the opportunity these individuals are seeking to launder money.
Terrorism Produces Insurer Risk

Insurers were not always recognized as having money-laundering risk. Although other types of companies may face greater risk, risk does exist for insurers. Insurers and agents can knowingly or unknowingly aid in money laundering and therefore, the financing of terrorism and other illegal activities. The following insurer and agent risks exist:

1. **Legal risk**, such as the possibility of lawsuits, judgments or contracts that turn out to be unenforceable which could adversely affect the operations or stability of the insurer.

2. **Reputational risk**, which is the loss of the insurer’s reputation. Insurers must have the public’s confidence; if that confidence is lost it will mean lost business even if the adverse publicity is not accurate.

3. **Operational risk**, which is the risk arising from failure of systems, internal procedures and controls leading to financial loss. Operational risk would include custody risk.

Insurers must take measures to prevent the risk that comes from money laundering tactics, whether it involves criminal or terrorism activities. Some measures are legally required of insurers.

The **Financial Action Task Force (FATF)** made specific recommendations regarding the steps insurers and their employees could take to reduce the risk terrorist activities presented. These include the following:

1. Identify their clients and potential clients using reliable, independent source documents, data and information.

2. Determine whether the client is acting on behalf of another person. Take reasonable steps to obtain sufficient identification data to verify the identity of that other person.

3. Identify the ultimate beneficial owner, and take reasonable measures to verify the identity of that beneficial owner so that the insurer is satisfied that it knows whom the person or entity is.

4. Obtain information on the purpose and intended nature of the business relationship and any other relevant factors.

5. Conduct ongoing due diligence on the business relationship and scrutiny of transactions undertaken throughout the course of that relationship to ensure that the transactions being conducted are consistent with the insurer’s knowledge of the customer/client and the beneficial owner, where applicable. This would include knowledge of their business and risk profile including the source of funds to the extent that is reasonable and practical.
Such due diligence is essential in some types of transactions and prudent in others of a lower risk profile. Much of the due diligence will be based upon the products current policyowners and future applicants are interested in, with cash value products being the most likely to be used in money laundering schemes.

**Legal Requirements Adopted**

Although many of the current procedures are new the concern is not. Since 1970 most financial institutions have had anti-money laundering (AML) laws, requiring reporting and record keeping procedures. Both the Bank Secrecy Act (BSA) and various NASD and SEC requirements have sought to prevent money laundering. As far back as 1970 the BSA required banks to report cash transactions over $10,000 via Currency Transaction Reports (CTA). The Bank Secrecy Act of 1970 was initiated for banks, but continuous changes and additions have included other institutions as well.

In 2001 came the USA PATRIOT Act (2001 Uniting and Strengthening America by Providing Appropriate Tools to Restrict, Intercept, and Obstruct Terrorism Act). This Act requires government-institution information sharing, including voluntary information among financial institutions. Customer identification verification and related due diligence is required, as is anti-money laundering programs in the financial services industry.

Title III of the USA PATRIOT Act, referred to as the International Money Laundering Abatement and Anti-terrorist Financing Act of 2001, requires financial institutions to address anti-money laundering (AML) provisions and amendments that were added to the Bank Secrecy Act. It is this act that extends the requirements to insurers.

Until 2002 insurance companies were thought to be at low risk for money laundering activity so they were exempted from the USA PATRIOT Act. This changed on 12/5/2005, with an effective date of 5/2/2006. Under the FinCEN final rule, pursuant to the BSA, insurers must now establish AML programs.

The USA PATRIOT Act dramatically increased anti-money laundering awareness and proactive requirements for the insurance industry. Today insurers must establish anti-money laundering programs that also meet the Bank Secrecy Act. Of course, not all insurers are considered at risk for money laundering, so this affects some types of insurers to a greater degree than others. Only those dealing in specific products are included. Broker-dealers already have AML requirements and are not required to duplicate those already in place by the newer insurance company requirements.

Under the Bank Secrecy Act of 1970 financial institutions are prohibited from selling, using or accepting money orders, bank checks, cashier’s checks or traveler’s checks for
more than $3,000 in currency. Larger amounts may only be accepted if the cash or cash equivalent and the purchaser’s identity is verified and recorded. Even when a financial institution does not sell these items, the rules still apply.

The final rule of the BSA requires insurers to implement procedures for obtaining customer identity information and to file suspicious activity reports when applicable. The Money Laundering Control Act (MLCA) prohibits any person from knowingly engaging in any monetary transaction in criminally derived property valued at $10,000 or more. For the agent selling automobile insurance, this might mean he or she could not insure a luxury car that was known to have been purchased with money derived from criminal activity. It is only necessary to know that money was somehow involved in criminal activity, not that these particular funds were involved or derived from a specific illegal act. Therefore, if the automobile is sitting in the driveway, already having been purchased, it is not necessary for the agent to know that illegal funds specifically purchased this car, only that the income of the car’s owner comes from illegal activity.

The Money Laundering Control Act added provisions to the Bank Secrecy Act (BSA) including a prohibition against structuring transactions, which means making multiple small transactions from one lump sum, the point of which is to conceal the origins of the money. By making smaller multiple transactions the depositor hopes to avoid the BSA’s reporting threshold, which would alert authorities. The multiple smaller deposits may be made in the names of multiple people, using the money launderer’s family and friends to open accounts. They might also use a single account, making multiple small deposits, each of which are under the reporting limits.

The Money Laundering Abatement Act adds criminal and civil penalties that can be up to two times the amount of the transaction, not to exceed $1-million for violations of specific BSA provisions. The MLCA provides for up to 20 years in prison and/or a fine twice the laundered amount not to exceed $500,000.

A part of the US Treasury, the Office of Foreign Assets Control (OFAC) may also place sanctions on financial institutions. These provisions prohibit doing business with identified enemies of the United States or with Specially Designated Nationals (SDN), as determined by OFAC and other government agencies. Many financial institutions routinely check their customers against this list. Should a professional encounter such a person (SDN), they must contact OFAC within ten days. If a Specially Designated National is discovered to already hold an open account it must be frozen, including any pending transfers.

The Office of Foreign Asset Control prohibits working with identified money launderers, which includes companies and countries as well as individuals. Sanctions are currently in place against the Balkans, Burma, Cuba, Iran, Iraq, the Ivory Coast, Liberia, North Korea, Sudan, Syria, and Zimbabwe. Members of drug organizations, such as Columbian drug cartels have also been identified as money launderers under the Foreign
Narcotics Kingpin Designation Act. These lists are updated continually, so there may be changes or additions to the previous list.

**Broker-Dealer Requirements**

Some insurance products or insurers are affiliated with broker-dealer firms. As a result, they may be subject to National Association of Securities Dealers (NASD) requirements. NASD has specific rules for companies offering certain products, such as variable annuities. Applicants must provide certain information when opening accounts, which includes:

1. Their legal name.
2. Place of residence.
3. Whether of legal age (usually 18 years old in most states).
4. Signature of registered representative who introduces the account and the signature of the member, partner, or officer/manager who accepts the account.
5. If the customer is a corporation, partnership, or other legal entity, the names of any persons authorized to transact business on behalf of the entity must be obtained.
6. NASD Rules 2110 and 2310 require additional information.
   a. 2110 requires the firm to maintain just standards of trade, and
   b. 2310 requires the firm to gather, as much as possible, information to help determine the suitability when making recommendations. Suitability information includes the client’s financial status, tax status, and investment objectives.

Customer Identification Programs (CIP) that broker-dealers adhere to must be appropriate for the size of their business. It should be regularly reviewed to ensure methods of verification are accurate and current. Additionally, there should be procedures to check a client’s name against the government’s list of known terrorists.

Customer Identification Programs may use non-documentary means of identification if necessary or desirable. Companies might use reporting agencies, references, checking account information, or other public sources when the identification used by their client has expired or when the client reports that their identification has been stolen or is otherwise unavailable.

Broker-dealers should notify their customers that such identity verification procedures exist. While suspicious activity reports are made without notifying the client, identity verification is not kept secret. Government issued identifications, usually a driver’s
license or passport, are typically required as part of the process. For businesses, a certificate of incorporation or a business license is used. Personnel are not required to verify whether or not the identification is genuine; they must merely record the information.

The Financial Modernization Act of 1999 (Gramm-Leach-Bliley Act) protects personal financial information that might be shared by financial institutions. Prior to this Act it was common for the information gathered to be sold to other institutions. It is not permissible to obtain client information from financial institutions under false pretenses. Institutions must give clients clear notice of how and when information will be shared.

Not all suspicious clients will appear on government lists. Citizens from non-cooperative jurisdictions should also be considered with caution, since people from such jurisdictions have a high incidence of money laundering.

**AML Program Requirements**

The Department of the Treasury has instituted procedures that must be followed when an agent, broker, or insurer suspects money laundering is taking place or could take place using insurance products. This brings up the obvious question: how is an agent to know such activity is occurring or has the potential of occurring? It is that question that anti-money laundering courses attempt to answer.

Ongoing training is required under the USA PATRIOT Act. Insurers must inform their employees and intermediaries (agents and brokers) of where training can be obtained or provide training so that they may learn to detect unusual or suspicious transactions. Employees must also know how to comply with the federal rules, regulations, and reporting requirements. Relevant manuals should be available to new employees who may not have yet had such training.

The PATRIOT Act also requires companies to determine which employees need additional training periodically in anti-money laundering. Some departments are likely to need more training than others. This would include treasury, operations, margin, credit, corporate security, audit units, and legal departments. Evidence of additional training should be maintained.

Anti-money laundering program requirements are now required for insurance companies. By May of 2006 insurers were required to develop and implement a written anti-money laundering program applicable to the products they sell. The program must be reasonably designed to prevent the insurance company from being used to facilitate money laundering or the financing of terrorist activities. Senior management must approve the program. The insurer must make a copy of its anti-laundering program.
available to the Department of the Treasury, the Financial Crimes Enforcement Network, or their designee upon request.

A key provision of the USA PATRIOT Act says employee training can be presented through various formats, including:

1. Live presentations,
2. Videos,
3. Online training programs, or
4. Other media formats.

Insurers must notify agents of the requirements or provide some means of instruction in-house. In all cases, the program taken must comply with anti-money laundering regulations.

Regardless of where the education is acquired, agencies must develop an independent audit program to test whether it has been effective. Insurers must stress the requirements with their intermediaries and urge compliance with all aspects of AML procedures. Every employee should receive written copies of consequences of non-compliance. There are civil, criminal, and disciplinary penalties for money laundering activities.

At minimum, the program was required to incorporate policies, procedures, and internal controls based upon the insurance company’s assessment of the money laundering and terrorist financing risks associated with its covered products. Policies, procedures, and internal controls developed and implemented by an insurer must include provisions for complying with the applicable requirements of subchapter II of chapter 53 Title 31, integrating the company’s insurance agents and brokers into its anti-money laundering program. Insurers must also obtain all relevant customer-related information necessary to ensure an effective program.

Each insurer will designate a compliance officer who will be responsible for ensuring that the anti-money laundering program is implemented effectively. This would include monitoring the agents and brokers to be sure they have complied with all requirements. It will be necessary to update the program as changes or additional knowledge requires it. Appropriate persons must be educated and trained so that they can adequately meet the requirements mandated.

Besides the compliance officer, there will be others who must receive appropriate education in order to understand and prevent money-laundering tactics using insurance companies and their products. This would include the company’s agents and brokers as well as other in-house employees. To accomplish this, insurers must either directly train their intermediaries and employees themselves or verify that such training has been obtained elsewhere. Some insurers will request their agents and brokers acquire this
education from outside companies that provide continuing education requirements. Agents will be required to submit their completion certificate as proof of compliance.

Insurers may use some type of testing to determine if their agents and brokers understand the risks imposed by money laundering. Insurers are required under the law to have some method of determining that their intermediaries understand the risks as well as complying with these requirements. The scope and frequency of the potential testing would be commensurate with the risks posed by the insurer’s products. The testing might be done in-house or by a third party. If performed in-house, the compliance officer may NOT be the person doing the testing.

Minimum requirements must be followed by agents and their insurers. The Bank Secrecy Act (BSA) requires financial institutions to establish anti-money laundering programs and to define the companies and insurance products that are subject to this requirement. The Bank Secrecy Act (Public Law 91-508) authorizes the Secretary of the Treasury to issue regulations requiring financial institutions to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, and regulatory matters, including the conduct of intelligence or counter-intelligence such as analysis of terrorism activity.

Originally signed into law on October 26, 2001, the USA PATRIOT Act Section 352 became effective on April 24, 2002 requiring anti-money laundering programs for all financial institutions. Although insurance companies have been considered financial institutions for some time, the Bank Secrecy Act had not defined “insurance companies” for their purposes. They also had not issued regulations regarding insurance companies. There was much to be considered since insurers had different sizes, locations and services. It was felt that education of agents was a key element in detecting suspicious activity and it was also recognized that few agents had the background to detect such activity, even if it was occurring with their own clients. Since money laundering is a key element in financing terrorist activities it was important to immediately address the situation.

Not all insurers are affected by money laundering activities. For example, it is unlikely that purchasing a health insurance policy would enable an individual to launder money, although fraudulent claims against a health care policy might occur. Terrorist members and other under-world groups (such as drug cartels) look for products that allow them to put their wealth into financial vehicles, and then withdraw untraceable funds. While term life insurance would not allow this to happen, permanent products such as universal life contracts would. These individuals do not care what amount is lost through early surrender penalties or other fees.
Know Your Customer (KYC)

A program regulated by the PATRIOT Act, Know Your Customer (KYC), requires verification of the client’s identity to the extent that is reasonable and practicable of any person seeking to open an account or place an application. The Act requires firms to maintain records of the information used to verify an individual’s identity and check the names against a government list of suspected terrorists. KYC requires risk-based determinations about:

- Their customers,
- Their customer’s sources of income, and
- Their customer’s expected transactions.

Compliance

Compliance is mandatory. Compliance will be monitored by the Department of the Treasury, through the Financial Crimes Enforcement Network (FinCEN) or its delegates, under the terms of the Bank Secrecy Act. Failure to comply with the requirements could constitute a violation of the Bank Secrecy Act.

The final regulations of 31 103.137 requiring insurance companies to establish anti-money laundering programs under the USA PATRIOT Act was issued on November 3, 2005. It is actually the insurance companies (the entities in the business of issuing or underwriting a covered product) rather than the agents and brokers who have a direct obligation to establish an anti-money laundering program. Since the insurer has the size to do so, they are viewed by regulators as better able to bear the administrative burdens and associated costs of complying with the regulation’s requirements. Insurers will have procedures, however, that require agents and brokers to adhere to specific anti-money laundering requirements (including education).

Suspicious Activity Reports Filing Requirements

The requirement to identify and report suspicious transactions applies only to insurance companies – not its agents or brokers. Insurance companies must obtain customer information from all relevant sources, which would include its agents and brokers. Any suspicious activity (based on this information) must be reported. A Suspicious Activity Report by an Insurance Company (SAR-IC) would be used by the insurer and must be used within 30 days of detecting the suspicious activity. Depending upon the situation, other forms may also be applicable. Prior to the PATRIOT Act insurers filed reports of $5,000 or more with the IRS. Most insurers did so voluntarily.

The threshold amount requiring an insurer to report suspicious transactions is at least $5,000, whether the cash payment is for a single policy application or multiple applications that total that amount or more. Payments made by check would not cause
concern. This threshold amount is not limited to insurance policies whose premiums meet or exceed $5,000; it includes a policy in which the premium or potential payout meets the threshold. Insurance companies are encouraged to voluntarily file Suspicious Activity Reports any time they seem appropriate.

When an insurer voluntarily files a Suspicious Activity Report they are protected from civil liability to the same extent as a company filing a Suspicious Activity Report would be when required by law.

A Change in Thinking

Life insurance agents can no longer accept clients at face value. They must be alert to the tactics of money launderers who use insurance products as the laundering vehicle.

Insurance agents and insurance brokers are specifically exempt from the definition of “insurance company” or “insurer,” which means they are not directly covered by the rules. An “insurance agent” is defined as a “sales and/or service representative of an insurance company.” This does not mean that agents do not have requirements regarding money-laundering activities since their insurers will be requiring specific new application requirements and mandated education on money laundering. Agents and brokers are an integral part of the insurance industry; they are certainly the ones most likely to be obtaining applicant information. This places agents in a critical position of knowledge regarding the source of investment assets, the nature of the clients, and the objectives and goals considered when purchasing insurance products.

While agents are exempt from the definition of insurance companies, the Rules require each insurance company to develop and implement policies, procedures, and internal controls that integrate the company’s agents and brokers into its anti-money laundering program. This places significant oversight responsibilities on insurers. It is never easy to oversee people working independently in the field. Education seems the only efficient way to integrate agents and brokers into the prevention of money laundering activities.

The final anti-money laundering rules apply to insurance companies offering covered products, as defined in the rule. The final rule focuses on insurance products possessing features that make them susceptible to being used for money laundering or the financing of terrorism. This typically includes life insurance policies with cash surrender value features and annuity products. Cash values can be redeemed by a money launderer or can be used as a source of further investment of tainted funds. By taking out policy loans against the cash values, these individuals have received legitimate funds in place of their tainted funds. Similarly, annuity contracts offer an ideal financial vehicle for laundering illicit funds or funds whose origins must be kept secret. Annuity products allow the policyowner to exchange illicit funds for an immediate or deferred income stream or clean funds upon redemption. Products without cash values, such as term life insurance...
products or group policies where there is additional control, do not pose the same opportunities to money launderers.

Those involved in terrorist activities (and criminals as well) must avoid the attention that sudden wealth would bring. Therefore, they look for means of merging their illegal funds with legitimate business funds, such as insurance proceeds. This is called the “integration stage” of money laundering because they are “integrating” their illicit funds with legitimate funds. They may do so in a variety of ways, including the purchase of money orders, opening and closing small checking accounts, and by purchasing insurance products.

Illegally gained funds are typically integrated close to the operations producing the profits. Therefore, if it is drug money from Columbia it is likely that the initial stage of money laundering will happen there or at least close by. In the layering stage the funds may be moved elsewhere. If the integration stage placed the funds in an unstable economy, this might especially be true.

The integration stage of money laundering is followed by the “layering stage,” which involves moving the funds through various investments, vehicles, or companies in order to distance the illicit funds from their original source. This might be the opening and closing of multiple checking accounts at various banking institutions, or by buying and cashing out insurance products. The funds are not always illegally gained; sometimes the goal is to conceal their origin. This would especially be true for terrorists and their contacts that do not want to be identified.

The final stage of money laundering is the “placement stage.” This is the process of introducing their illegal profits into the financial systems of our country. This would include buying legitimate businesses, real estate, or any item that would “place” their funds into our financial systems.

To recap: first comes integration stage, followed by the layering stage. The final step is the placement stage.

A Global Problem

Money laundering and the problems it creates for financial institutions around the world have not gone unrecognized by the international community. While there are no firm estimates (after all, the point of money laundering is to hide the activity) it is thought to be in the billions of dollars. The International Monetary Fund believes it could be as much as $600 trillion annually.

It is not surprising that money laundering is a worldwide problem. Money launderers seek safe havens to cleanse their money. Some countries make that easier than others. Terrorists and criminals want locations that pose the least risk to their activities. That
might be a terrorist-friendly country or simply one that is not financially developed in their available technology. Eventually terrorists and criminals want to move their money through stable financial systems, such as those in the US.

One might believe that insurers would be able to tighten controls making such transactions difficult. However, it seems no matter how careful legitimate companies become or what procedures they put in place, criminals and terrorists simply become more creative. That is why we must be aware of what indicates money-laundering activity.

As the international community recognized the role insurers could play in money laundering activities they focused on creating corrective measures. The Financial Action Task Force (FATF) was established in 1989 at the G-7 Summit in Paris as a result of international concern. Starting with 16 members, today membership has grown to 31 countries and two international organizations. The Financial Action Task Force developed recommendations that looked at insurers and focused on those businesses involving the underwriting and placement of life insurance and other investment related insurance having cash values or surrender values.

Criminals have considered insurance products a good avenue for laundering illicit funds for some time. A 2002 federal grand jury indictment against five Colombian nationals laundering cocaine money using life insurance policies demonstrated how easily it could be accomplished. Called Operation Capstone, the investigation revealed approximately $80 million had been laundered through insurance products. Although there had already been concern regarding the use of insurance products for money laundering, Operation Capstone illustrated the ease with which it could be accomplished.

The Colombian drug cartel did not purchase only US insurance policies. Policies were bought in continental Europe, the United Kingdom and in smaller jurisdictions, such as the Isle of Man. Using narcotics proceeds from the United States and Mexico, the traffickers bought approximately 250 life insurance policies in the Isle of Man alone. The insurance policies had values ranging up to $1.9 million each. They were taken out in the names of cartel associates and members of their families. Usually they would cash out part or all of the policies prematurely, even though there were penalties of as much as 25 percent or more. While a legitimate policyholder would try to avoid such penalties, these individuals considered them a business expense in the process of laundering the illicit narcotics proceeds.

During the last five years a number of Suspicious Activity Reports were filed that reference the use of an insurance product in suspected money laundering activity. For example, several reports described large, lump-sum purchases of annuity contracts, followed almost immediately by fund withdrawals. Sometimes the entire balance was withdrawn soon after purchase.
Most participants in the drafting of anti-money laundering legislation felt that education was the key to success. They felt it was important not to simply focus on educating the insurance company principals, but also their employees, agents and brokers who are, so to speak, on the front lines of the money laundering process.

### Covered Products

Since anti-money laundering requirements will involve those who deal with specific products, what does the Department of the Treasury Financial Crimes Enforcement Network (FinCEN) mean by any “insurance product with features of cash value or investment” under the definition of “covered products”? Their definition of “covered products” includes:

1. **A permanent life insurance policy**, other than a group life insurance policy;
2. **An annuity contract**, other than a group annuity contract or charitable gift annuity; and
3. **Any other insurance product** with features of cash value or investment.

The purpose of including the language of number three, “any other insurance product with features of cash value or investment,” is to ensure that any newly developed products in the life and annuity field having cash value characteristics that could be vulnerable to money laundering would automatically be covered by the requirements. It is not intended that group life insurance policies or group annuities (with or without these characteristics) would be covered since group policies are administered differently than individual contracts are. There is typically a trustee or administrator involved and there are specific guidelines that govern group contracts making their use difficult for money launderers.

“Covered products” do not include term, credit life, health, title, property, casualty insurance, or group products. Charitable annuities and reinsurance or retrocession contracts are also not considered covered products. If cash values become involved, this could alter how the definition affects them.

Currently insurance companies are not subject to 31 CFR 103.121 requiring them to implement a Customer Identification Program (CIP) and obtain minimum mandatory information verifying the identity of a customer. Even so, other applicable Bank Secrecy Act regulations require insurance companies to obtain and retain identifying information from customers in specific circumstances. Insurance companies must obtain all relevant and appropriate customer-related information necessary to administer an effective anti-money laundering program.
The Financial Action Task Force (FATF) studies the methods and trends used by individuals to launder money. Their objective was sharing of information among law enforcement and financial institutions while also providing a basis for informed decisions on anti-money laundering and terrorist financing policy for the United States and other concerned countries.

FATF recognized the vulnerabilities in the insurance industry. The global insurance industry provides risk transfer, savings and investment products to a variety of consumers around the world, including individual policies, business insurance, and governments. As we have discussed, those intending to cleanse their wealth or conceal its origins use cash value products to legitimize their funds. Research conducted by FATF noted inherent characteristics of the insurance industry that make it particularly vulnerable to money laundering (ML), that characteristic being the cash values that some products contain. Inconsistent regulation and supervision across the industry was also noted as providing unique opportunities that were likely to be recognized by money launderers. When FATF looked at the insurance industry there were unusually low money-laundering detections in place, especially when compared to other financial industries of comparable size.

While there are no specific facts on the extent to which the insurance industry has been exploited by money launderers there is no doubt that it has taken place, as witnessed by Operation Capstone. The specific aim is to prevent not just crime lords from using the insurance industry, but specifically to prevent terrorist organizations from doing so. Worldwide the insurance sector generates premiums of some USD 2.941 trillion per annum\(^1\) so the potential for abuse is obvious. In some product areas, premium dollars have doubled in the last ten years. The insurance industry gathers most of their premium through agents and independent brokers so that the insurer itself has limited control. While there is some life products marketed directly to the public without intermediaries (agents and brokers) the bulk does come directly from a field staff. An increasing share of the market is being sold by financial service industries, such as banks. While the individuals selling these products must still hold an insurance license in most cases, the fact that they work within another industry may affect how they understand insurance money-laundering schemes. Only a very small percentage of policies were found to have been purchased over the internet or through telephone marketing. However, any significant increases in such sales could affect how anti-money-laundering procedures are considered.

**Nine Identified Money Laundering (ML) Methods**


\(^1\) www.swissre.com
1. **Single Premium Life Insurance Contracts**
   Single premium products of all kinds enable the money launderer to purchase a policy with a lump sum payment. This product is ideal because the purchaser can deposit a significant amount of money at one time. Since the annual premiums will be paid from an account, which has to be funded with the total amount, what would seem to be a lower ML risk life product actually bears the features of the higher risk single premium policy.

2. **Early Policy Redemption**
   While every agent has probably experienced a policyholder who surrendered his or her policy early despite penalties, a client who routinely does so should be considered a potential money launderer. It is very often combined with high single premium or deposit account life insurance policies. A conspicuous fact is that some of the respective clients opted for early redemption even when it seemed very financially disadvantageous to do so. Some of these policies experienced unusually high penalties (as much as 40 percent in some cases). An agent must be suspicious when the policyowner shows little regard for the loss he or she will experience. Such early policy redemptions do not always happen immediately, though some will. Often the policyowner will wait a year or more to redeem their policies.

3. **Claim Fraud**
   Claim fraud can occur with any type of insurance product since the intent is to receive capital from the claim rather than policy cash values. This represents a general structure of criminal behavior in the insurance sector by transferring illicit funds into clean money paid out as claims from an insurer. Agents have seen claim fraud for many reasons; money laundering is often not involved. Since claim fraud often does not involve money laundering only those cases that seem to continually happen or seem suspicious from a premium payment standpoint might point to money laundering.

4. **Cash Premium Payments**
   Most people want a paper trail for their own protection. Therefore, most people pay major bills by check or some other method that can be proven if necessary. While the agent would issue a receipt for cash, that is not the normal method used to purchase a life or annuity product. This would especially be true if the premium required was a large amount.

   In the past when policyholders paid with cash, their agent merely deposited it into their personal business account and wrote a personal business check to be submitted to the insurer. This method works quite well for money laundering since the agents themselves presented the vehicle for cleansing illicit funds.

5. **“Free Look” Periods For Newly Issued Policies**
   Insurance policies allow a specific period of time following issuance for the new policyholder to “look it over” and decide if he or she is satisfied with the contract terms. Agents usually have a few clients who choose not to keep their policy, but usually it has
to do with their client’s finances or decision as to whether or not they actually need the protection.

When money laundering is the objective, individuals purchase policies they never intend to keep. These are often purchased with illicit cash. The individual may buy one very large policy or a number of smaller policies through various agents. When the policy or policies arrive the buyer cancels them and receives a refund in the form of a check from the insurer. This has allowed the money launderer to mingle his or her illicit funds with legitimate insurer funds, receiving “clean” money back.

Agents should question a sale if the buyer seems more concerned with the size of the premium (preferring larger premiums) than with the benefits of the policy being purchased and pays the premium with cash. It is important to note that it need not be a cash value policy since the goal is not withdrawing values but rather canceling the policy soon after issuance.

For Example:

Ben buys a nursing home policy requesting the highest benefits available. The premium comes to several thousand dollars and Ben pays with cash. Once the policy is issued and delivered, Ben cancels it and receives a refund check from the insurer.

The policy selected will be some type that produces a significant premium amount. The individual may buy the same type of policy from several different insurers, canceling all of them upon issuance and delivery. Our example of a nursing home policy would probably not be significant enough in size unless Ben could pile on enough benefits to make the cost high (and worthwhile). The more likely type of policy would be an annuity or an Investment Bond.

6. Collusion of Customer Intermediary and/or Insurer Employee

Most agents and employees of insurance companies are honest people, but those who deal in illicit funds are sharp observers. They often recognize individuals who can be manipulated. Of course, there are also dishonest people who need no manipulation at all – just the promise of wealth.

There have been several cases of collusive behavior between the customer and the agent or between the intermediary and the insurer. The intermediary (an agent or broker) involved accepted illicit funds and transferred them in exchange for high commissions. There was a case in Canada where a drug trafficker purchased a life insurance policy informing the agent that the funds came from illegal activity. The agent charged a higher commission for issuing the policy. Three months later, the policyholder cashed in the policy.
7. Third Party Premium Payments
This typology pays the premiums on policies through third parties. A third party is a person who is not the policyholder and who has not been subject to identification by the writing agent or issuing company. Therefore, neither the agent nor the insurer can verify the person or the relationship to the policyholder.

8. Risks Involved in International Transactions
International transactions exist in a variety of ways. It may be a simple payment of premiums from a foreign bank account or the payout of policies to a foreign jurisdiction. Exercising a foreign transaction is not necessarily a sign of money laundering of course. Typologies include those with more complex transfers where the goal may be the concealment of money origins. When transfers are complex (moving money via bank accounts or checks through different jurisdictions) complicating the control of the legal source of funds, it should be considered a suspicious situation. When money laundering is the goal, it may involve foreign customers and customers domiciled abroad who seek insurance policies through domestic or foreign intermediaries. The policy payout is usually to a foreign jurisdiction.

9. Fraudulent Customers, Insurers, or Reinsurance Companies
FATF noticed that criminals established or took over complex corporate structures and then entered into business relationships with insurers to get coverage. The purpose of the various commercial insurance contracts was to invest illicit funds. In some cases this was facilitated by the fraudulent setting-up of insurance or reinsurance companies for the purpose of laundering money. The criminals were able to invest proceeds of crimes into legal business entities and initiate transfers of money behind the veil of an insurance company or reinsurance company.

Money Laundering Indicators Not Unique to Insurance Products
Some aspects of money laundering are not unique to the insurance industry. Of course, money laundering will exist anywhere there are vehicles to accomplish the illegal act. The following are characteristics of money laundering wherever they may occur.

1. Large One-Off Cash Transactions
The use of cash in situations that would not normally call for cash should always cause suspicion. This is especially true today when we have so many methods available to us to pay for goods and services. The insurance industry is one that is unlikely to need cash to acquire the products they produce. If insurers were retail stores we might not be so suspicious of cash sales, but we are not retail dealers; we are agents who would normally expect to receive a check for our products.
2. Use of False Addresses

Most agents would assume it was a simple error if their customer’s mail was returned to them as undeliverable (and in the past that would be a correct assumption). Today, however, given the number of cases in which fraudulent customers have been involved (accounting for 7% of total cases), agents must be aware of the potential that exists for receiving purposely incorrect information from clients. Agents must now check key personal data provided by their customers and increase the attention they give to verifying its correctness. Most agents will request a piece of identification during the application process, or follow whatever instructions are given by their insurers.

3. Overseas Business From Higher Risk Jurisdictions

There was a time when only a handful of agents expected to receive business from foreign countries but times have changed. International transactions are one of the riskiest from the standpoint of money laundering and this is especially true of certain high-risk jurisdictions. Of course, that does not mean that all international transactions are forms of money laundering but it does mean that agents and insurers alike must be aware of the potential involved in such cases. Most insurers will be requiring enhanced identity verification and monitoring procedures to guard against potential money laundering tactics. This is particularly true for business coming from NCCTs (non-cooperative countries and territories) and tax havens, since the re-routing of funds through foreign locations and intermediaries is commonly used to further screen the origins of the funds.

If the Treasury Secretary decides a money laundering concern exists involving a foreign jurisdiction or an institution, they may require record keeping and reporting of certain financial transactions, including identities of those involved.

Policyholder Characteristics and Behaviors

Most of our policyholders are not terrorists and are not attempting to launder money. That’s the good news. Some of our potential policyholders may be trying to use insurance products to launder illicit funds or to hide the origins of their premium dollars. That’s the bad news. How can an agent or broker tell the difference?

A customer’s profile is the most likely way to differentiate between the typical policyholder and the individual who has a different agenda. The profile should look at both the individual’s financial and personal data as it relates to the products they are interested in purchasing. Some indicators will pertain only to the insurance industry while others would be universal to all industries. At all times the agent must be aware that having these policyholder characteristics does not necessarily signify illegal behavior. Even so, when a policyholder raises suspicions it is necessary for either the insurer or the agent/broker to verify the reasons for the activity or characteristics.
There are particular clients that would automatically be considered high risk. This would include citizens of uncooperative jurisdictions that have been identified by FATF as money laundering havens. While coming from such a jurisdiction does not automatically make the individual or company a criminal it should alert the agent to the possibility.

Companies or clients whose funds come from offshore banks or uncooperative jurisdictions must also be considered questionable.

Finally, senior foreign officials and their family members or political figures whose transactions of funds could be the result from embezzlement or misuse of public funds must be considered as potentially suspicious.

Even when these individuals are not on OFAC or SEC lists, they have a higher potential risk so agents must use caution when doing business with them. To consider the previous list in respect to filing a suspicious activity report (SAR) some elements would be considered, including:

1. Whether or not the client has been with the agent or insurer for an extended period of time. A client that has been with the agent or insurer long enough to have a record of normal insurance transactions could be viewed without suspicion, whereas a new policyowner might warrant suspicion.

2. How the client was obtained. Was he or she a referral from a trusted long-term client? Did the client call the agent with a request to purchase a specific cash value product? If so, how did he or she hear of the agent? These questions can easily be asked and the answers could prove valuable when assessing the threat of money laundering activity.

3. Whether the client’s business is more likely than others to involve money-laundering opportunities. For example, cash intensive businesses offer more opportunity to launder money than those that seldom use cash.

4. The client’s home country may indicate a greater likelihood of money laundering activities since some jurisdictions are known for doing so.

Should an agent decide that suspicious activity is taking place, and especially if the agent is concerned that a terrorist act might occur, he or she must call the Financial Crimes Enforcement Network’s Financial Institution’s hotline: 1-866-556-3974.

In addition to filing a SAR, the agent would be required to contact the proper authorities immediately.

All SAR reports are confidential and it is not necessary or even advisable that the individual in question be told of the report’s filing. If an agent is subpoenaed in response
to the filing of a suspicious activity report, the agent is not required to provide any information. He or she should immediately contact FinCEN.

If an insurer receives a subpoena, it should not confirm or deny the report. The insurer should contact the Chief Council at the FinCEN office at 1-703-905-3590.

**A Known Criminal or Criminal Associate or Relative**

Many people have relatives or past associates that are less than angelic. That does not automatically make the individual a terrorist or criminal. However, when suspicious activity and criminal association are combined it should raise suspicions that must be either confirmed or denied. While it is unlikely that individual agents or brokers would be aware of a person’s past criminal history there are cases where an individual is so well known that it would be hard not to have such knowledge.

Usually suspicion is not raised because an agent or broker is aware of a client’s past criminal history. Instead it is how they purchase or use policies that would cause concern. That concern would then be cause for effective customer due diligence procedures and the use of normal information sources that may provide necessary knowledge to prevent money-laundering activity.

**Erratic or Abnormal Use of Policies**

Most policyholders purchase a policy for a specific reason; once purchased the contracts are allowed to perform as they were designed to perform. A person who buys a policy for money laundering purposes generally does not use them in a typical manner. Those who are using insurance contracts to launder money may deposit unforeseen funds (that do not seem consistent with their income or lifestyle), make abrupt withdrawals, or have unjustified intervention of third parties who make deposits or withdrawals on the policyholder’s behalf. There may be an unacceptable refusal to provide personal information or information to intervening third parties. Ideally, the agent should know their customers well enough to be able to assess such events and make evaluations, but it is unlikely that we will know all of our customers well enough to do this. What we can do is know our customers well enough to recognize abnormal behavior and report such incidents when prudent.

**High Premiums Compared to Verifiable Income**

Agents are now required to obtain reasonable information regarding their client’s incomes and finances. Through the sale of financial vehicles we have the ability to ask questions of a client that we would not ask in a social situation. Data concerning a client’s economic standing is vital for assessing the consistency of behavior and of the transactions being initiated. Because insurers have a history of paying particular attention to their individual customers they have been able to make long-term
investments that other industries that lack specialized client knowledge cannot do with short-term speculative financial instruments. Therefore, it may actually be easier for insurers to protect themselves from illicit funds and those that launder them.

Most insurance products are purchased through continual payments, usually monthly or quarterly, over a period of time. These payments are typically related directly to the policyholder’s personal earnings, rather than originating from other financial sources. When there is inconsistency between a customer’s verifiable economic profile and the scale of investment in insurance products, it is a significant indicator of possible money laundering, which would certainly require further investigation.

**Lack of Concern for Charges or Costs**

The typical policyholder is always concerned about surrender penalties or other costs that might remove part of their policy values. Anyone who is not concerned must have a reason. Agents must ask themselves what that reason might be. If the lack of policyowner concern exists because he or she has no intention of terminating prior to maturity, which would activate a penalty, there is probably no reason for concern. If, on the other hand, the policyholder terminates a contract prior to maturity triggering a significant penalty there is valid reason for concern since it is a sign of money laundering risk. Money launderers seldom care what policy costs exist because they consider them a valid cost of doing business (screening their illicit funds through an insurer, receiving back funds that appear legitimate).

**Undue Interest in Payout Options**

A client who withdraws sums that trigger losses of contract values (whether penalties or other costs) displaying no concern regarding these losses should raise suspicion. When a new policyholder is less concerned with policy benefits and more concerned with potential payout options, agents must recognize the risk this signifies. It means that the client may initiate behavior at a later stage, even if not currently, that might signify money laundering.

**Change of Beneficiary**

While it is not unusual for a legitimate client to change their beneficiary, a widely observed and effective indicator of risk relates to repeated changes in the beneficiary designation of a policy. Repeated and unexplained changes increase the chance that money laundering is occurring. Such events gain further significance in those cases when the relationship between policyholder and beneficiary is not clearly established. Payout requests may be made on the basis of death, with proceeds going to unsubstantiated beneficiaries.
Insurance on Assets That Appear Inconsistent With Income

Criminals are like the general population: they insure the assets they acquire. Insurers that are asked to insure assets that have been acquired with no means of income are an indicator that illegal activity exists. It is an effective indicator of inconsistencies between the customer’s economic profiles and the values or assets they are seeking coverage for.

Early or Suspicious Claims

It is known that general insurance is affected by money laundering risk. In other words, insurance products that do not produce a cash value may also be at risk from money laundering activities. Typologies demonstrate that money launderers also may purchase contracts and submit suspicious claims or claims very early in the policy. A claim placed by a policyowner after a very short period from the issuance may be related to frauds or may signal that the coverage was sought for money laundering purposes. Agents who stay in contact with their clients are those who are most likely to recognize fraudulent behavior.

When opening a new account/application for an individual the agent has never met before, there is specific money laundering indications to be aware of. While many of these seem very similar to the previous characteristics these should specifically be applied to the new client filling out an application.

These characteristics would include:

1. An unusual interest in the insurer’s compliance record with government reporting requirements. The individual might ask the agent whether he always confirms client income, for example, stating that privacy is very important to him.

2. A reluctance to provide government identification (such as a driver’s license or passport) may be an indication of possible money laundering activities or intent.

3. Vagueness on the part of the new client regarding information about his business activities or income sources should arouse the agent’s suspicions.

4. If the new client has difficulty describing how his business operates or seems to lack knowledge regarding it, suspicion should be aroused. Agents can determine this very casually through normal conversation and should do so since it is a valuable tool in detecting ML activities.

5. If the new client seems to be acting on the behalf of another but refuses to provide identification information of that person or company, the agent should consider the client suspicious. Comments such as “He wishes to remain in the background” or “That is classified information” are strong indications of money laundering intent.
6. If the individual indicates a desire to make insurance transactions that do not make good business sense the agent must consider the person suspect.

7. Transactions that seem to be evading BSA requirements are always a risk indicator. This would include making multiple policy applications using cash in amounts below normal reporting requirements.

Of course, if any identification does not seem genuine the agent must be suspicious. While the agent is not legally required to investigate the authenticity of produced identification material, if it seems to be false, it is necessary to note this with the application sent to the insurer’s underwriters. In fact, any indication the agent has of potential money laundering activities must be reported to the insurer. Certainly knowledge of use of illicit funds to purchase insurance products must be reported by the agent.

Anytime an existing or new client is not concerned with the product’s performance the producer’s radar should be on. Most of our clients have a definite concern with policy performance so a lack of concern would be a prime indicator of illegal intent. If the applicant or existing client also displays a desire to avoid required government reporting requirements there would be little question as to their intent.

Sometimes illegal intent is not as obvious so it is important to recognize other signs that might indicate suspicious activity. This would include (but may not be limited to):

- A desire to deal only in cash or cash equivalents (money orders, cashier’s checks, or traveler’s checks).
- Multiple fund transfers, often going to and from countries listed as non-cooperative or high risk.
- Multiple wire transfers for no apparent business purpose.
- Purchase of long-term use products, but either withdraws funds from or closes the vehicle prematurely. Especially if more than one of these products is used in this manner it would indicate ML activity.
- Makes requests to wire transfer funds from the insurance product to a third party or company without any apparent reason for doing so.
- Deposits bearer bonds followed by requests for distribution of funds.
- Fees for premature withdrawals or other costs associated with product use do not seem to concern the client. The client may even suggest the agent receive higher commissions than normal.
Product Characteristics and Maintenance

Once an insurance policy is purchased, producers are often in a position to better understand their clients and any possible connections that might exist to money laundering activities. While the following activities do not individually indicate money laundering activities, when combined or exercised repeatedly the producer (agent) should consider them suspicious.

1. **Policy Payments from Third Parties**
   Policies are typically purchased and paid for by the policyowner or the insured, which may or may not be the same person. If the policyowner is not also the insured, the writing agent probably understood the relationship between the two when the policy was applied for. This information would likely be relayed to the underwriter of the insurer.

   A third party is a person that was not part of the original application so the agent and insurer have no knowledge of their identity or relationship with the insured or policyowner. Involvement of third parties could signify that the policyowner is a figurehead on behalf of the real provider of financial resources invested in the policy, with the intent of concealing the origin of the premium dollars or investment dollars.

2. **Multiple Sources of Funds to Pay Premiums**
   It is unusual for premium funds to originate from multiple sources, even when all sources are tied to the policyowner. Most people signify one specific source for their premium payments, often utilizing automated payment methods such as checking account drafting. When premiums are paid from multiple sources it may indicate operations of layering or the integration stage of money laundering.

3. **Significant Premium Top-Ups to a Policy**
   Sizeable or regular premium top-ups, especially if not anticipated at the time of policy application, is a key indicator of money laundering risk for investment types of life products.

4. **Overpayment of Premium**
   Overpayment of premium, especially when followed by a request for repayment to a third party or another jurisdiction, is a sign of money laundering. This is an effective method of exchanging illicit funds for legitimate insurer funds. It is also effective in hiding the origin of funds. Insurers often detect this, however, and may refuse to finalize the transfer or report the request for transfer to the designated authorities.

5. **Using an Insurer Like a Bank**
   Insurance companies are offering more financial options than ever before. Many investment-type life policies offer considerable flexibility in the making of additional premiums or early redemption. When these features are used in ways resembling banking activities (making additional premium payments and frequent partial
withdrawals) this is an indicator of possible money laundering. The risk is increased if transferring funds are received or paid to numerous accounts or to foreign jurisdictions. This especially applies if the jurisdiction is considered risky or non-cooperative or if the foreign exchange restrictions are in force in the receiving jurisdiction.

6. Early Redemption
As we have discussed, early redemption is a common method of laundering money. It enables an individual to invest tainted money and remove legitimate money. Therefore, individuals who seem interested in withdrawal options over their interest in policy benefits should be suspected of money laundering. Of course asking such questions does not make a person a money launderer and their motives may be quite innocent. If, however, policyholders actually exert their right to terminate a policy before its maturity, the agent should consider this a potential money laundering risk. This would especially be true if no logical reason was given for the withdrawal or policy termination and the transaction was significantly uneconomic for the policyowner. Some money launderers look for policies that will not penalize the agent (require return of commission) for early surrender since these individuals do not wish to alert the agents to their activity.

7. Unusually High Commission Charges
Studies have shown that policies paying unusually high commissions are often selected by money laundering groups or individuals. In some cases, the intermediary (agent or broker) was directly or indirectly involved in a money laundering operation. In other cases, the intermediary sensed the transactions were shady and therefore selected a higher commission for him or herself.

Customer Due Diligence (CDD)

There is little doubt that customer due diligence (CDD) is required on all levels of the insurance industry if money laundering activities are to be minimized. The quality of customer identification is pivotal to preventing the use of insurance products for terrorism purposes. Under the USA PATRIOT Act, verification of new account holders will be focused on. The Treasury Secretary issued regulations establishing standards for customer identification that must be applied to all new account applicants. Insurers must:

1. Verify the identities of the new account holders.
2. Maintain records of the information used to verify a person’s identity.
3. Consult government lists of known or suspected terrorists and associated terrorist groups prior to issuing policies.

Failure to identify potential terrorists and criminals will allow money laundering to continue unchecked. CDD should be considered as a specific feature of financial intermediaries’ risk management. Therefore, failure to adequately identify an applicant
early in the application process merely magnifies the problem later in the business relationship if the agent must correct the omissions. Why would an agent not properly identify a new applicant? The Financial Action Task Force stated in their 2004-2005 report that the most likely reasons include lack of expertise, time pressures, and lack of appropriate insurer requirements. Intermediaries are not directly accountable for customer due diligence but they are accountable for following insurer requirements. Since it is obvious that intermediaries, such as agents and brokers, have direct contact that the insurer does not have, it is sensible and prudent for insurers to require specific identification processes during an application completion.

Agents and brokers are those most likely to initially notice suspicious activity. It is the agent, during face-to-face encounters that would recognize strange client behavior or an economic profile that may justify filing of a Suspicious Transaction Report (STR). It is self-evident that agents and brokers must comply with anti-money laundering procedures that enable their insurers to prevent the activity. Agents are in the best position to realize if policies are being written on assets that do not seem consistent with the individuals’ income or economic level, for example.

One of the concerns regarding placing too much responsibility on the field staff that meet face-to-face with their clients is the insurance producer’s possible reluctance to ask the necessary questions of new applicants. Agents have incentive to make the sale, not discourage it. It is hard to imagine Agnes Agent saying to her new applicant: “I can’t take this application because I can’t verify where your premium dollars are coming from.” That is why education is necessary so Agnes Agent realizes she is not required to state this. Instead, she should complete the application, attach her notes regarding the fact that cash was used and she could not see means of income, and forward it to her insurer with the application.

It is not always easy to recognize suspicious activity. In general, agents were not trained in money laundering activity so they were not alert to the signs. Surveys have revealed that agents typically believed the insurance business was not at risk for money laundering activities. However actual risk, as measured by the amount of cases involving insurance products and businesses, does exist.

Once money is deposited into some type of financial vehicle, such as a cash value insurance product, the origins of the illicit funds has already been partially obscured so it becomes easier to layer and place the partially laundered funds. The link to the money’s origins may be very difficult to determine at this point since premium may be paid from a legitimate bank account or by a cashier’s check. Not all such transactions are money laundering of course; it may be a repositioning of assets from a Certificate of Deposit into an annuity; the client may have received an inheritance or even lottery winnings. It is the job of the agent to determine, within reasonable means, the origin at the time of application.
For example, an agent might ask:

“Okay, Mr. Peterson, do you wish to reposition an asset into your new annuity or would you prefer to make periodic payments from your checking account?”

Or state:

“I am so sorry, but I am not in a position to accept cash. If you could deposit that into your checking account, I can accept a personal check and allow you time to make your deposit.”

Seldom would a client be reluctant to state where premium dollars or a deposit originates. In fact, more often the client is proud of their ability to save if that is the case. A new applicant that is reluctant to disclose the origins of premium dollars would be suspicious.

Unlike the banking industry, insurance companies have not seemed to establish information-sharing devices as they relate to money laundering, which reflects their belief that it is a banking problem rather than an insurance industry problem. Criminals were quick to recognize this delusion of agents, brokers, and insurers.

Many regulators accused insurers of doing an inadequate job of monitoring and training their agents. In their defense it is very difficult to monitor a group of mostly self-employed contractors.

As competition from various financial markets intensified, insurance products emerged to compete in the worldwide market place. Many of these new products seemed more investment oriented than traditional insurance. Unfortunately the market expansion and product changes were not developed with a corresponding understanding of the money laundering tactics used by criminals and terrorists. In the past, there did not seem to be risk of criminal and terrorist infiltration since the products were not attractive to their goals. Today’s products offer cash values that fit their needs very well.

Cash value life insurance products appear to be a primary target of criminal and terrorist infiltration since substantial funds can be invested in widely available insurance products. Many of these products have a high degree of flexibility. While the honest policyholder appreciates these elements, money launderers love them. They offer the ability to legitimize illicit funds.
Policy Features and Provisions

Life insurance contracts have various features and provisions that reflect the type of product it is. While all life insurance contracts will have some similarities, there will also be differences.

Premiums

Insurance contracts have premiums; a **premium** is the payment the insured makes for his or her insurance coverage. The premium due date will be listed on the policy. The insured has the option of paying premiums monthly (usually through a bank draft), quarterly, semi-annually, or annually. Annual premiums may be less than quarterly or semi-annual payments. If the insured pays their premiums monthly through a bank draft costs are likely to be less than monthly payments the insured must manually send in.

Policies have grace periods for payments. This is the amount of time allowed past the premium due date to pay the premiums without lapsing the policy or providing proof of insurability. If the premium is not paid within the grace period the policy will lapse and the life insurance coverage ends (except in policies that have provisions to pay the premium from cash values). Reinstatement may require proof of insurability.

Policy Options

Cash value or participating insurance policies offer three sets of options: nonforfeiture, dividend, and settlement options.

Nonforfeiture Options

Nonforfeiture options provide an avenue of premium refund. If the owner discontinues paying premiums the insured may:

1. Surrender the policy for its cash value, if any;
2. Convert the policy to a paid-up contract of the same type but with a reduced face amount; or
3. Convert to a paid-up term policy for its full face amount for a period usually shorter than the original policy. This is called extended term insurance.

If the policy is participating the insurance under the reduced-paid-up option continues as participating. Insurance under the extended term option often becomes non-participating. Some companies might continue the extended term as participating but at higher rates.
Policies commonly have provisions that automatically convert to extended term insurance if the owner discontinues payments and fails to elect one of the other available options.

**Dividend Options**

Dividends are paid on insurance policies participating in the insurance company’s earnings. It is usually expressed as “par” for participating and “non-par” for non-participating insurers. Mutual insurers are commonly companies that issue dividends to their policyowners. Stock insurers may issue both non-par and par policies, but most stock insurers issue only non-par policies.

A par company generally pays dividends in cash, but typically no money is actually transferred unless the policy is paid up (all premiums have been paid). The insurer applies the cash dividend towards the next premium that comes due.

Dividends may be “accumulated at interest.” The insurance company retains the dividends in this situation and accumulates them at not less (and usually more) than the interest rate specified in the policy.

Dividends may also be used to buy paid-up additions to the policy at net rates. This is an opportunity to acquire low cost insurance since these additions are purchased at net rates. In other words, the insurance is purchased without the expense allowance. This can be especially important if the insured has experienced declining health since this additional coverage is purchased without regard to current health or even occupation (some occupations are considered high risk) when the dividend is paid. Paid-up additions must be the same type as the policy the dividend is paid on. Paid-up additions may be selected for current dividends at any time without proof of insurability.

Another dividend option is one-year term insurance. Under this option the amount of insurance that can be purchased by the dividend is often limited to the cash value of the policy. If the dividends exceed the amount required to purchase the maximum term insurance the policyowner may elect to use the excess for a different option available under the policy.

If the policyowner wants additional death protection either the paid-up insurance or the one-year term dividend option is a good choice. If the insured is more interested in saving money for retirement the accumulate-at-interest dividend option could be chosen. Interest paid on dividend accumulations is taxable income but annual increases in the cash value of paid-up additions are not generally subject to current income taxation. As always, it is important to consult with a tax expert.
Settlement Options

The generally accepted method of paying proceeds from a life insurance policy is by lump sum distribution. However, two alternative methods offer periodic payments:

1. The interest-only option, and
2. Annuity options.

If an annuity option is elected there are several choices available, including lifetime income options, installments for a specified time period (such as twenty years), and installments of a fixed amount of money each month or each year. The amount of income available and the time over which income is available is directly related to the amount of money deposited into the distribution vehicle (the annuity). Obviously the more money deposited the more income one will receive.

The word "annuity" means "a payment of money." The insurance industry designed them to do just that. Choosing an annuity payout option requires understanding of how payout options work.

There tends to be standard options offered:

1. **Lifetime Option (Single Life):** For as long as the annuitant lives he or she will receive a check each month for a specified sum of money. The payment amount received each month will never change. This option will pay the maximum amount in comparison to other available annuity payout options. Selecting the lifetime option is a gamble. If the annuitant lives a long time, he or she could collect handsomely over time. If their life is cut short, the insurance company will keep any balance left unpaid. No leftover funds will be distributed to any heirs.

2. **Joint-and-Survivor (Two or More Lives):** Under this option, the insurance company will make monthly payments for as long as either of two named people lives. In some cases, it could involve more than two lives, but usually there are just two people involved as annuitants. This option is often utilized by married couples. However, the couple need not be married. Any two people named will be honored by the insurance company.

3. **Life and Installments Certain:** The key word here is CERTAIN. The "certain" period of time is usually either ten or twenty years, but may be another time period also. This option states that should the annuitant die prior to the stated "certain" time period, payments would then continue to the beneficiary until that specified number of years had been met. On the other hand, the annuitant may receive payments longer than the "certain" period stated. That is where the "life" part comes in.
4. **Cash Refund Annuity:** If the annuitant dies before the amount invested has been paid out by the insurance company, then the remainder of the invested money (plus interest) will be paid out in monthly installments or in a lump sum to the named beneficiary or beneficiaries.

In each of these options, the insurance company pays nothing beyond the agreed period of time:

1. **Single Life** = nothing after the death of the annuitant (no beneficiary designated money);
2. **Joint and Survivor** = nothing after BOTH named people have died (no beneficiary designated money);
3. **Life and Installment Certain** = nothing after the death of the annuitant or until the stated time period; whichever comes last (so a named beneficiary could receive something if the annuitant died prematurely).
4. **Cash Refund** = nothing after the full account has been paid out whether to the annuitant or a beneficiary.

A lifetime option will mean a higher monthly payment to the insured but the insured is gambling that he or she will live long enough to receive more than they deposited into the annuity. If the annuitant dies before they receive the amount deposited the insurance company keeps any remaining money; heirs receive nothing. However, when considering retirement financial security is the first consideration, not potential beneficiaries.

Under the interest-only option the insurer retains policy proceeds paying interest to the beneficiary. A minimum interest rate is guaranteed with the actual interest payment determined by the amount the insurer earns. Although there are minimum guarantees, the amount actually paid has traditionally been higher.

### State Required Provisions

Each state will have specific state requirements. While these may vary from state to state (so we are not quoting any specific state’s provisions) there does tend to be some basic requirements in all states. There will be some provisions *mandated* by the state, some provisions *allowed* by the state and provisions the insurer feels are necessary. Some provisions are included to protect the insurer from excessive claims although that is more likely to occur in health contracts than in life contracts.
Dollars and Sense

Chapter 4: Life Insurance

Generally all states have specific items they feel are necessary for consumer protection, which may include incontestability, misstatement of age (sometimes even misstatement of sex), deferment, nonforfeiture, loan values, grace periods and reinstatement provisions. It is always important to know one’s own state laws; as an insurance professional this is an agent’s duty and moral obligation to his or her clients. It is also an obligation the agent has to the companies they license with.

Incontestability

The incontestability provision prevents the insurer, following a specifically stated period of time, from rescinding ( contesting) the policy on the basis of misstatements made or omission of facts on the original application. While the applicant may not have intended to leave out information or state the facts incorrectly, during the initial period following policy issuance the insurer could rescind the policy for such occurrences. States want that period of time to be reasonable so they impose incontestability requirements.

Exact wording will vary based on state requirements but the incontestability statement may be similar to the following:

“This policy shall be incontestable after it has been in force during the lifetime of the insured for a period of two years from the date of issuance, except for nonpayment of premiums.”

If premiums are not paid in a timely manner, the policy will lapse independent of any omission or misstatement of application facts. The courts have interpreted the clause in favor of consumers, allowing it to become an agreement to disregard consumer fraud. It makes sense to do so since it would be impractical to gather enough evidence or find sufficient witnesses to prove the applicant intended to defraud the insurance company. The insurers also realize that misstatements and omissions in the application sometimes result from agents who wish to receive a commission. In other words, the applicant claims he or she did in fact disclose the information to the agent, but the agent failed to disclose them to the insuring company.

One advantage of incontestability clauses that agents and policyowners alike may not be aware of is how it affects beneficiaries. The clause is valuable to them because it prevents delayed settlements resulting from long and costly court action if the policy has been in force for more than two years.

Misstatements in the Application

Generally misstatements concern the applicant’s age, but it can involve the stated gender as well. The incontestability clause does not excuse the misstatement of age or sex since they are primary life insurance rating factors. Obviously the older an individual is the greater the risk to the insuring company. The gender is also a factor since women...
generally live longer than men. However, such misstatements would seldom cause the policy to be rescinded although the insurer is allowed to adjust premium rates and back charge to the inception of the policy for any additions that are owed in premium. If the insured is deceased, an adjustment would be made in the face amount of the policy to correctly reflect the premiums that were paid. In other words, the beneficiary is paid the amount of proceeds the premiums would have purchased if the age and sex had been correctly stated.

The author is not aware of any adjustments stated in policies for surgical sex changes. Generally issues of this nature must experience a court case before it becomes legally addressed in policies. However, even in surgical sex changes it is likely that insuring factors would be based on the gender at birth since all those attributes (risk factors based on age and gender) would still exist.

**Deferment Clause**

In the 1930’s insurance companies experienced multiple policyholders withdrawing or borrowing cash values from their policies simultaneously. This forced insurers to sell assets at depressed prices, causing the companies substantial financial losses that would not otherwise have occurred. Since then life insurance companies have **been required** to include a clause giving them the right to defer payment of cash or loan values in policies for a period not to exceed six months, unless the loan is for renewal of premiums.

The deferment clause does not apply to death proceeds when the insured dies, although it may apply to lump-sum withdrawals of proceeds left with the company under the interest-only option or the prepayment of any guarantees under an installment or life income option.

**Nonforfeiture**

Since cash-value contracts contain nonforfeiture provisions, the cash-value rights in a policy are not forfeited if the policy is discontinued.

**Loan Values**

Many types of life insurance policies develop cash values. Term insurance never develops cash values, so this would apply to the various forms of permanent life insurance. Some term policies are coupled with such things as annuities but only the non-term portion would acquire cash values.

If the policyowner wants to keep his or her life insurance policy in force while still acquiring cash he or she can arrange a loan from the insurer up to the cash value in the policy. The insurer lends the money at the guaranteed policy rate; the rate varies so it is necessary to consult the policy and policy attachments.
Some policyowners may feel it is unfair to charge interest when they withdraw their own policy values but there is a valid reason for doing so. Insurance companies take into consideration the investment income of the cash values when computing premium. Therefore, if the policyowner withdraws the cash values the insurer must be compensated for the investment income they lose.

Originally the purpose of policy loans was to provide a source of funds for policyowner emergencies but people soon realized they could use the money for any purpose – not just emergencies. Savvy investors pulled their cash values through policy loans and invested them in short-term vehicles at higher rates to earn a profit. For example, a policyowner earning 5 percent on his cash values might withdraw the money and invest in short-term financial paper at 8 percent, earning a higher rate than he could have in his life insurance policy. This became a widespread occurrence and it put insurance companies at a competitive disadvantage.

The National Association of Insurance Commissioners, partially as a result of this problem, approved a model bill permitting a policy loan provision for new policies that allowed periodic adjustments of the policy loan rate. The adjustments are based on specified indexes of long-term corporate bond yields. The maximum loan rate for each policy must be determined at regular intervals, at least once a year but not more often than once in any three-month period. The rate charged may be increased if the increase would be 0.5 percent per annum. It must be decreased if the decrease would amount to 0.5 percent per annum. The NAIC model bill permits a fixed policy loan interest rate of 8 percent in place of the variable rate.

**Grace Periods and Reinstatement**

Insurance contracts provide a grace period during which the insured may pay their premiums without losing insurability. While it is never wise to pay premiums late, the grace period does allow policyowners to maintain their policies even if premiums are paid late, as long as they are paid within the grace period allowed. Grace periods are 30 or 31 days following the premium due date. If late premiums are paid within this time period the policy remains in effect, as though premiums had been paid on time.

If premium is not paid by the end of the grace period policies without cash value will terminate. Those with a cash value will be placed on the appropriate nonforfeiture option. If death occurs during the grace period any unpaid premium will be deducted from the life proceeds the beneficiary receives.

Policyholders may reinstate their lapsed policy within specified time periods. He or she will be required to pay all back premiums prior to reinstatement and provide proof of insurability. The length of reinstatement varies but usually the time is three to five years. If reinstatement is sought by the insured within a short time of lapse proof of insurability
may be no more than a simple statement made by the policyholder. For longer periods of lapse the insurer may require a medical examination similar to what a new application would require.

Allowed Policy Provisions

Some policy provisions are allowed since they do not violate state or federal requirements. State laws generally allow insurers to include restrictions for such things as suicide, aviation, and war, for example.

Suicide

If an individual was suicidal it would be logical to first buy a life insurance policy naming loved ones as beneficiaries. This would be considered “adverse selection.” Obviously it would not benefit insurers to have very many people buy a policy and then commit suicide. Therefore, there is a restriction in life insurance policies restricting benefits when death is the result of suicide. Policies will not pay benefits for suicide within two years from the date of issuance (a few restrict payment for one year). Insurers must still return all premiums that have been paid but no death benefit is due.

Aviation

Aviation restriction provisions are usually limited to planes flown by nonprofessionals and the insured individual. Flight in commercial airlines would not be restricted. Usually the provision states exclusion “for aviation deaths, except those of fare-paying passengers on regularly scheduled airlines.” Military aircraft is typically excluded since that would imply active duty in the military, which would be covered by military life insurance. Military exclusions may read similar to: “exclusion of deaths in military aircrafts only; exclusion of pilots, crew members, or student pilots and aviation death while on military maneuvers.” There was a time when only policies issued during periods of war would include these clauses but today, with America involved in non-declared war conflicts, these are more likely to appear in contracts.

War

War clauses vary widely so it is always important to review the actual policy for details. Some policies will totally prohibit payment for deaths resulting from war in any capacity while others will prohibit payment only for specific situations. If the death occurred while the insured was in the military, for example, but the death itself was not related to war activities the policy might still pay benefits to the beneficiary. The insurer will refund any premiums that were paid or an amount equal to the policy reserve.
General Provisions

Insurance companies certainly underwrite and create policies with profits in mind. It would actually be unethical for them to do otherwise since they must remain in business if they are to pay out benefits to those that deserve them. Even state and federal laws recognize that insurers must remain profitable. With that goal in mind, there are general provisions designed for the protection of the insurer, which in turn protects policyowners.

Deduction of Indebtedness and Premium Refund

Indebtedness to the insurer from a policy loan will be deducted from any proceeds payable to a beneficiary at death, or from cash values upon surrender of the policy. Insurers may refund unused premiums if the insured dies with an insured term paid for, but this is not generally required by law.

For example: Ivan Insured mails a quarterly life insurance premium payment to his insurance company on December 15th for the policy term from January 1 through March 31. On December 28th he unexpectedly dies from injuries incurred in an automobile accident. His insurer may or may not automatically refund his quarterly payment to his estate, depending upon company practice.

His insurance company is not required to return his premium but may do so if it is their normal practice to do so. Even when an insurance company does not ordinarily return unused premium, they may do so upon request. Therefore, estate administrators typically do request refund of unused premiums as a matter of standard estate settlement practices.

Change of Beneficiary

When an application is taken for life insurance coverage the agent requests a primary beneficiary listing. The beneficiary may be a single person or multiple people. When multiple people are named the application will request a listing of each beneficiary percentage of proceeds upon the insured’s death. For example, it may state: Mary Maxwell: 50% and James Higgins: 50%. If the agent is wise, he or she will also request a contingent beneficiary in case the first named beneficiary or beneficiaries predeceases the insured.

In most policies the applicant reserves the right to change the primary and contingent beneficiary designations. In many cases change of beneficiary is merely a matter of filling out a new beneficiary designation form, but some companies may require the original policy be returned along with the completed form.
Assignment

In property insurance contracts the consent of the insurer is needed to assign benefits to another, but this is not typically the case for life insurance contracts. However, the life insurance company is likely to require notice of assignment be filed with their home office. This is usually considered a consumer protection measure.

Beneficiary Designations

While it is not mandatory, the wise policyowner will always name an individual or individuals as policy beneficiaries. Seldom would entering “estate” on the beneficiary line be wise. Policy benefits bypass probate proceedings when a person is the listed beneficiary. The designation may be either revocable or irrevocable. Most people would always choose a revocable designation, meaning the insured can change his or her named beneficiary any time they wish to, and usually as often as they wish.

If the beneficiary designation is irrevocable all policy rights are vested in the beneficiary and the policyowner may not assign the policy or borrow on it without first getting the beneficiary’s permission. An irrevocable beneficiary designation may be either reversionary or absolute. In reversionary designations the policy rights revert to the policyowner if the beneficiary dies first. In absolute designations the value of the policy is included in the beneficiary’s estate for the beneficiary’s heirs.

It is important to be precise when listing beneficiary designations. An agent is unlikely to ever allow his or her client to list “Granddaughter Nancy” for example. While there may currently be only one granddaughter named Nancy there is no way to know what the future may bring. It is important to list full names so there is no doubt as to who the intended beneficiary is. If available, listing the beneficiary’s Social Security number is also advisable.

Policy forms allow both a primary and secondary beneficiary listing. The secondary beneficiary is often referred to as the contingent beneficiary designation. The contingent beneficiary would receive the life insurance proceeds if the primary beneficiary had died prior to the insured individual.

Some third party rights do exist in life insurance contracts. Beneficiary rights are determined by the type of beneficiary designation and by the ownership of the policy. In some cases the beneficiary is both the beneficiary and the policy owner; certainly he or she can then exercise all policy rights by virtue of contract ownership. The owner may exercise all policy rights including policy loans and assignments regardless of the type of beneficiary designation.
If the beneficiary is not also the owner but is revocably designated as beneficiary he or she has a **contingent interest** in the policy. This is an interest that is contingent upon the subject dying prior to the named beneficiary and prior to revoking that person in favor of another. A revocable designation may be changed to someone else if the insured wishes to.

A person named as an irrevocable beneficiary has a **vested interest** in the policy. He or she can deny the owner permission for policy loans, assignment and any other action relating to the policy that would affect the proceeds the irrevocable beneficiary would receive, assuming he or she outlives the insured.

Creditors’ rights to the insured’s cash values and life insurance proceeds are generally restricted by common law, federal statutes, and state statutes. Sometimes creditors’ rights depend to some degree on how the beneficiary designation is stated. If the insured dies and the beneficiary designation listed “estate” it will likely make the funds available to creditors. It may be possible to legally attach a life insurance policy but the availability of any cash reserves or values would depend on the policy’s provisions. If removing the cash values will not cancel out the policy, the courts may allow it. Even so, if the right to collect is a policy option to be exercised by the insured, the insurance company is not obligated to pay the cash value until the insured elects that option, so creditors may not be able to actually receive the cash values. Creditors do not have the right of election and the courts will not typically force election on the insured. Creditors can claim cash values only through formal bankruptcy proceedings.

In the case of death, the courts have ruled that policy proceeds then belong to the named beneficiaries, as long as “estate” was not listed rather than an actual person. As a result proceeds are not subject to the insured’s creditors because they now belong to the third party beneficiaries. If the insured owes taxes, usually collection is limited to cash values, not death proceeds.

Two federal statutes concern creditor’s rights to life insurance: federal tax liens and bankruptcy. The federal government can collect its tax claims directly from the insured’s insurance company, although it is limited to the policy’s cash values. If the insured dies prior to paying the taxes he or she owes the tax claim is collected the tax limit is the cash values immediately prior to death.

When a policyowner files bankruptcy the Federal Bankruptcy Act determines how life insurance policies are treated.

State statutes have generally exempted life insurance from creditor’s claims, although each state will have variances. State statutes take precedence over the Federal Bankruptcy Act. *Crossman Co. v. Ranch in New York* stated exemptions on life insurance proceeds were enacted for “the humane purpose of preserving to the
In many states the exemption extends only to policies payable to the insured’s spouse and children. In some states it extends the protection to any person that was dependent upon the insured, which could even include aged parents. Some states extend this creditor protection to any listed beneficiary (that is not the estate). In most states this protection includes not only the death proceeds but also any cash values. A few states provide protection from creditors to the beneficiaries as well as the insured. If the statute is not applicable to the beneficiary’s creditors the insured may provide this protection by including a spendthrift trust clause in the policy settlement agreement. This clause gives the beneficiary protection from their personal creditors. A spendthrift trust clause requires the policyowner to elect an installment settlement option. Only the proceeds held by the insurer for the benefit of the beneficiary are protected; any money the beneficiary receives is then available to creditors.

Every time an application for life insurance is made the applicant has several decisions to make. These decisions concern beneficiary designations as well as ownership and policy options. All decisions are important.

**Policy Payments**

Policyholders and beneficiaries may receive payments under the terms of their life insurance policy. The payment amount depends upon a variety of factors relating to the policy. Obviously a term insurance policy would not have any cash values whereas a universal life insurance policy might. Even in a permanent policy, such as universal life, payments would depend upon how many and how long premiums have been paid. It would also depend how the insurance carrier handles policy costs.

**Cash Values**

All forms of permanent insurance, such as universal life, have cash values if sufficient premiums have been paid. The policy will state the amount of cash value available each year the policy remains in force. A cash value policy is expensive if the insured does not keep the policy active for a sufficient length of time; short term life insurance needs are best suited to term coverage (with no cash values). Experts recommend cash value policies be kept for no less than ten years. For those that do select cash value products and keep them long enough to make the cost worthwhile cash values can be effective in supplying retirement income or emergency cash.

Cash values may be accessed at any time at the policyowner’s request. However, there are other options besides just withdrawing the funds. These options include:
1. **Borrowing against the policy.** Once money is borrowed, if the insured dies prior to repaying the loan, the amount borrowed will be subtracted from the benefits that are payable to the listed beneficiaries.

2. **Buying reduced coverage.** If the insured finds he or she is not able to pay the premiums but still wants to keep the coverage, it is possible to get reduced permanent life insurance. The cash value is used to buy a smaller policy that is paid in full.

3. **Changing to term insurance.** If it becomes difficult to manage the premiums in a cash value life insurance policy, the insured could elect to reduce the cost by using cash values to purchase a paid-up term life policy, assuming sufficient cash values exist to do this. When the term contract ends, coverage also ends. This may be referred to as extended term life insurance.

### Dividends

For insurance purposes, dividends are refunds of premiums for those who have participating policies. A participating policy (called a *par policy*) is one that has a premium fixed at an amount higher than the insurance company believes will be needed to cover the costs of providing protection. The extra payment is returned to the policyholder as a dividend after the actual insurance costs are determined. The policyowner is guaranteed not to have to pay higher premiums than those stated in the policy. The dividends can be used to pay the lower premiums, buy additional insurance, or earn interest if left in the policy cash values.

Nonparticipating policies, referred to as *non-par policies*, have premiums fixed as close as possible to the actual cost of providing the coverage. As a result, there would not be any dividends paid to the policyowner.

### Proceeds

Proceeds are paid to a listed beneficiary when the insured individual dies. To receive the proceeds the beneficiary must file a claim with the insuring company. Once the proper filing has been made, the individual will receive the face amount of the policy, called the *proceeds*. Proceeds can be received in one of several ways, called *settlement options*. The settlement options include:

1. **Lump-sum option**, which allows the beneficiary to receive the entire amount in cash.

2. **Amount option**, which allows the beneficiary to take a certain amount each month until the money and interest run out.
3. **Time option**, which allows the beneficiary to take the money plus interest paid out over a specified period of time (such as ten or twenty years) on a monthly installment basis.

4. **Interest option**, in which the cash values are left on deposit with the insurance company to earn interest indefinitely. The recipient simply withdraws the interest earning periodically as the need for cash arises.

5. **Lifetime income option**, in which the individual receives a guaranteed income for their lifetime. The payments consist of interest only so they can never run out.

### Special Clauses

While all contracts can be intimidating, some of the most difficult contract language is found in insurance policies that have special clauses. Special clauses may do multiple things, depending upon the insurer’s intent. These clauses might limit the insured’s rights or grant the policyowner important privileges. Agents must understand and be able to communicate the options or limitations special clauses contain.

Nearly all policies have clauses of some sort. They might include:

1. **Incontestable clauses**, which state that the insured has a “temporary” policy for a specified length of time; incontestability of the coverage is typically two years. If the insurer finds the insured has lied or misrepresented the facts on their application for the specified period of time the company may refuse to pay a claim or even rescind (take back) the coverage entirely. Of course a life insurance policy would end anyway upon the death of the insured, so rescission is not really an issue if the insured has died.

2. **Waiver-of-premiums clause**, which waives payments for a stated period of time, usually six months. This provision is particularly important if the insured becomes disabled, sick, or injured and cannot work for a period of time. Without this provision failure to pay the premiums, even if it is due to a disabling injury, will mean lapse of coverage. Some policies will pay the premiums on the insured’s behalf up to the age of sixty-five, so this provision is a significant benefit to the insured individual and his or her family.

3. **Automatic premium loan**, which will pay the premium on behalf of the insured if he or she fails to do so. The premiums are charged against the policy as an automatic premium loan so the policy does no lapse. Interest will be charged on the loan.

4. **Accidental death benefit**, which might also be called an **indemnity**. An indemnity clause promises the policy will pay an extra amount if the insured dies as a result of an accident rather than natural causes. We sometimes hear this referred to as a “double indemnity clause” when the insurer will pay double the
face value when death results from an accident. It can be more than a double indemnity, depending upon contract terms; it could be triple indemnity or even quadruple indemnity. There are often some identifying requirements for indemnity payment; for example, the insured may have to die within 90 days of the accident to receive these additional proceeds. If he or she lives longer than the requirement, it would not be treated as death by accident, but instead it would be considered death by natural causes (so no indemnity payment would be available). Most policies do charge an additional premium for the accidental death benefit, but it is typically very low since accidental death is not as likely as natural death. The actual premium will depend upon risk factors for the insured.

5. **Assignment clause**: if the insured has kept the right to change his or her life insurance beneficiary, the policy can be assigned to another party to serve as security for a debt or loan. Some banks will lend money on a life insurance policy if it can be assigned to them, for example. If the insured does not have the legal right to assign the life insurance policy, then the beneficiary would have to give permission to do so.

6. **Non-cancelable clause**, which allows the insured to continue an insurance policy for as long as the premiums are paid. It cannot be canceled for any reason other than nonpayment of premium. This becomes very important if the insured develops a medical condition that renders him or her uninsurable.

7. **Guaranteed insurability option**, which allows the policyowner to buy additional insurance at some point without proving his or her current insurability. Like the non-cancelable clause this becomes important if health status changes, making the insured uninsurable. Typically, this option is available to new applicants who are under the age of forty who are buying a whole-life, universal life, or endowment policy. Although the availability of buying additional insurance depends upon contract language, often additional insurance is available every few years until the age of forty. The amount of additional insurance available may be limited so it is important to read the policy carefully.

8. **Exclusions**: some policies exclude certain situations entirely from coverage. For example, non-fare airplane flight is often completely excluded under the policy exclusions. Exclusions tend to be similar in all policies but since there may be some variance the buyer should shop around if a particular exclusion applies that he or she would like covered by their life insurance policy. In many cases, if death results from an exclusion companies will return premiums if the death occurs within the first two policy years.
Contract Use

Life insurance contracts have the ability to be used in many ways. Obviously life insurance, both term and permanent, are used to insure an individual’s life, but they may also be used in other formats. Businesses may offer their employees group life insurance where the master contract is held by the employer. Employees receive a certificate of insurability.

Group Insurance Principles

Group insurance can include any type of policy that covers groups of people that have come together for a common purpose. That purpose is often employment, but it can also include fraternities, labor unions, or any type of organized group. It is important to note that the group may not be formed for the sole purpose of buying insurance. Group insurance can include virtually any type of product, but usually we think of group insurance in terms of health coverage. Group life insurance may not be as desired as group health insurance, but it is commonly offered by employers or employing organizations. Since underwriting is performed on the group rather than the individuals within the group, those with health issues will find group life insurance beneficial.

Eligible Groups

Any time an employer sponsors group insurance one eligibility requirement is sure to include employment. Exactly what constitutes a group, however, can be far more encompassing. Precisely what constitutes an eligible group for group insurance purposes is regulated by law since it pertains to specific tax benefits.

Single Employer Groups

When XYZ Company brings in an insurer to underwrite an insurance plan for its employees, XYZ becomes a member of the most popular group: a single employer making group benefits available to its workers. Employers can be sole proprietors, partnerships, or corporations. All sizes of companies can offer group insurance plans to their employees – even if only one employee exists. However, it is medium and large-sized companies that are most likely to do so.

Multiple Employer Trusts (METS)

When the group is comprised of two or more small employers who have come together to purchase a single group plan, they are called multiple employer trusts, or METS. The purpose of smaller employers joining together is one of finance: they generally receive the advantages of a large employer by increasing their size through unity. Some
plans have minimum requirements (usually 10 members), so by joining together companies can escape the limitations of their small size.

A separate trust is formed to handle the group business, including collection of premiums and filing claims. Multiple Employer Trusts may be sponsored and administered by insurance companies or non-insurance organizations.

**Unions, Associations, and Other Groups**

Organized unions are groups of workers who perform the same type of job or work in the same type of field. Federal law requires a trust to be established to collect funds and administer the employee benefits.

The group does not have to be an employer or labor union. Any group of people can form an association or other type of group and purchase insurance on a group basis. Types of eligible groups in this classification must adhere to state laws on group eligibility. The group can be old car collectors, members of a community club, lawyers, or any group of people that come together for a common purpose (other than obtaining group insurance benefits). The group need only have a common relationship that is recognized by law.

**Creditor-Debtor Groups**

When an individual borrows money they may become part of a creditor-debtor group. Creditor-debtor group insurance is offered by the lender to those who borrow money from them. Usually a form of disability or life insurance, its purpose is to protect the creditor if the debtor becomes disabled or dies prior to the debt being paid. Some credit policies are individually issued rather than group issued.

As we know, group insurance is based on a common purpose of membership. In the case of creditor-debtor groups, the common purpose is the lending and borrowing of money from a common institution (a bank, savings-and-loan institution and so forth). Labor groups and other associations may offer this type of protection based on the group association as employers or members of the group. Credit unions offer such protection to their members, for example. Credit card companies also offer creditor-debtor insurance; their common purpose is the credit card itself.

In most types of group insurance, it is the group that is qualified and the insurer can usually be sure that the health or other risk factor involved is well mixed. When a credit card company or other loosely defined group markets creditor-debtor disability or life insurance products, members choose individually whether or not to accept the group coverage. Since those most likely to accept would have a reason for doing so (poor
health for example) the possibility of adverse selection is much greater. Adverse selection is the likelihood of high-risk individuals outnumbering healthy members.

**Underwriting Advantages**

A major advantage of group insurance is the ability to avoid individual underwriting. As a result, all members of the group have equal access to the benefits involved. Of course, insurers are still concerned about adverse selection (having primarily high-risk members), but this is much less likely to happen in a mixed group of people coming together for a common purpose other than obtaining insurance. Insurers view the group and underwrite it as a group. The effect of this is balancing of risk. The younger and healthier members will balance out the risks of those who are older and less healthy. Group plans also tend to have a shifting membership. In a company, some employees will stay for many years, while others will stay only a short time. There is a constant shifting of ages, health conditions, and other factors that relate to group underwriting. Group plans require the participation of a high percentage of eligible people to ensure that the plan is not composed primarily of those who are likely to have claims.

Group plans have requirements regarding when employees or other members join the group insurance plan. For employees, it is usually required that they sign up for coverage soon after being employed, usually within the first month. This prevents the employees from only joining the group insurance plan when they know they will need the benefits.

When the group is a MET, underwriting is stricter because the insurers know the group is made up of multiple smaller groups. The MET sponsor, often an insurance company, decides what requirements the smaller groups must meet in order to be accepted for the group insurance plan. If the MET is made up of enough small groups, the underwriting exposure for the insurer ends up being as favorable as that for one large group.

As we know, it is an advantage for the insurer to have a large group since the law of large numbers then lessens their risk. The law of large numbers says that a sufficiently large unit of insureds will balance out the risk of claims. The younger and healthier enrollees will have fewer claims than older or sicker members and yet pay the same approximate premium rate. The larger the numbers involved the easier it is for the insurer to evaluate their potential risk and set the premium accordingly.

Just as large numbers help insurers, it also benefits those that are members of the group. The advantage that most enrollees are most familiar with is price. Another advantage is group acceptance regardless of existing health conditions or other claim risks. Group acceptance means that every person has equal access to insurance protection.
Group underwriting is becoming stricter, however. As the costs of medical care continue to rise, and since it is primarily health insurance that is underwritten for groups, insurers are looking closer than ever before at the people who make up the group.

**Keeping Current with Business Needs**

Even when a business appears to have insured the necessary risks, it is prudent to constantly review the insurance portfolio. Most professionals feel an annual or even semi-annual review is necessary. Probably everyone would like to be able to simply submit an application into a vast marketplace that brings instant results, and to some degree that may be possible. Independent agents will submit proposals through multiple insurers, but that doesn’t guarantee that all risks have been recognized. It is seldom that simple. While there have been online sites for pricing automobile insurance with multiple companies (often through a single broker) business insurance has been slow to follow suit. Part of the reason is the complexity of business insurance. It is unlikely that a business owner shopping online would recognize all of his or her potential risks. Therefore, he or she could overlook some financially devastating possibilities.

Agents and brokers rarely appreciate consumer price shopping but it does actually benefit everyone. When insurance companies must become competitive they tend to put out better products and promote service. In the end, this is a benefit not only to consumers but also to the servicing agents.

It can be time consuming to continually price shop for existing clients, but such service often brings about a loyalty that would not exist otherwise. Loyalty also brings about referrals. In addition it is generally harder to seek out and obtain new accounts. It is easier to renew and update existing business.

Most consumers, regardless of the type of coverage being considered, want to know one thing: *how much money for how much protection?* Because consumers feel inadequate they often remain with an unsatisfactory policy because they have no idea how to compare products. On the other hand, a consumer may change coverage merely because another agent recommends it, without really understanding if the change is beneficial or not. Consumer laws are often passed due to the few who are unethical, causing all producers to jump through additional legal hoops.

Agents face a dilemma that may not have a satisfactory answer: the public perceives agents as greedy people who want to make a sale at any cost to the consumer. While there may be some agents that fit this description the majority are professionals who are educated and strive to deliver products that fit the consumer’s needs. Of course, agents must earn enough commission to support themselves and their families, but seldom is that the first consideration for career agents. Unfortunately, many consumers will never benefit from the professional agent because he or she is so mistrustful of the industry.
The Informed Consumer

It would be wonderful if all our business clients were informed on insurance products. While a few companies offering group coverage do have a person in charge of such things, most do not. Therefore, the agent must expect to spend enough time to fully explain all aspects of the proposed insurance. There is no doubt that it is easier to sell a product when no other agent is also offering a counter-proposal, but whether there is a competitive situation or not it is important that the buyer understand what they are purchasing. When the buyer is misinformed or does not understand the results can cause a backlash on the agent as well as the insuring company.

An agent cannot expect their clients to blindly stay with them year after year. Unlike individual policyholders, businesses are more likely to shop the marketplace on an annual basis. This means regardless of any work you may have previously performed, they are willing to change agents if prices or benefits seem better elsewhere. Agents working the business insurance market must continually offer prices and benefits that are competitive. Therefore, agents in this marketplace must continually price companies and products and be willing to change loyalties when necessary.

Providing a Quote

Part of an agent’s job is providing insurance quotes. This is one of the major steps in acquiring new business and keeping old business on the books. Most agents provide a new quote each year to existing clients. The new quote compares their current company with others the agent represents. “Captive” agents may not be able to do this since they represent a single company. In that case, their yearly quotes will be more of an annual review of the existing coverage.

Although there are variances, providing a quote tends to follow these steps:

1. Outline the client’s current coverage
2. Outline other available coverage in an apples-to-apples format
3. Make note to the client of extenuating facts (such as waiting periods that might apply, benefits that cannot be compared to existing coverage, and so forth)

Many agents initially mail the annual quote to their clients and then follow it up with a telephone call. Some agents may present the quote in person, especially if the agent feels a change in companies is necessary due to price changes or benefits available. Unlike the policies written on individuals, where constant replacement may be frowned on by
regulating authorities, business insurance often changes from year to year. Such change is considered to be a normal business routine.

The quoting process is not as difficult as it may at first appear. The Buyer’s Guide to Business Insurance\(^2\) lists seven steps to the quote process rather than the three we have listed. Their view is from the consumer’s standpoint and assumes that the agent is not operating in the client’s best interest. While this can certainly be true in some cases, career agents have learned that the client’s best interests are also their own. It is usually easier to keep a current client than find a new one. Therefore, career agents try very hard to work in a way that will retain current business.

An effective agent will keep informal contact with all their clients. This might be something as simple as a timely birthday card, a quarterly newsletter, or occasional telephone calls. Business insurance is purchased as a means of avoiding loss. Therefore, it is very important that the agent act in the best interest of the business by offering coverage for potential losses. A quarterly newsletter can be an effective way of introducing ideas in business insurance. A business could be severely affected if the agent is negligent. A substantial loss could actually shut down a business. Of course, the business owner has some responsibility in maintaining adequate insurance, but if he or she is relying on the knowledge and professionalism of their agent, the blame may be legally placed on that agent in court. Therefore, besides the fact that commissions are lost when adequate insurance is not recommended, it is also a means of avoiding lawsuits.

Every agent that is not captive to a specific company owes it to their clients to shop the marketplace for products. Although the time spent can be considerable it is usually worth it. As an agent gathers quotes for one account, much of the information will carry over to other accounts as well so the time is well spent.

Nearly every business is advised to shop the marketplace. If the current agent does not offer this service, they are likely to find one that does. If an agent has not shopped the marketplace for a particular account for several years, the loss of that client is likely. This is especially true if their premium rate has continually climbed. Business owners typically notice any expense that rises year after year. If their agent has not adequately explained the price increase there is no doubt that the client will be exploring other options.

Agents do not always have sufficient policy options available to them for some types of accounts. Unfortunately, some types of business insurance are difficult to obtain at reasonable rates, especially for small companies with few employees. Even when the agent wants to provide benefits at an affordable rate, they may not be able to. When insurers withdraw from a specific field of coverage it typically means a hardening

\(^2\) The Oasis Press, Copyright 1994
insurance market. Just like investments, some types of insurance experience both a soft market and a hard market. When markets become hard (rising costs to insure with a lowering profit margin) companies will opt out, canceling existing policies and refusing new business. Agents must search the marketplace for available coverage, sometimes with unsatisfactory results.

When the existing agent is unable to secure the coverage at desired rates it is likely the business will seek out other agents in the hope of obtaining the coverage they want at a price they are willing to pay. Of course, the business may not be successful, but it does open up the opportunity for another agent to pick up the client.

It is common for a business to use the services of multiple agents or agencies. This is not only common; it is sensible. Agents tend to have areas of expertise, but seldom do they know everything about various types of coverage. Agents who learn to work together, often through the same agency, are able to bring together the knowledge of multiple agents to the benefit of their clients. While we would like to be able to “do it all” this is not realistic. Experienced agents realize both their strengths and weaknesses. Knowing this is an asset since it allows agents to combine their efforts with other agents whose strengths and weaknesses compliment each other. When agents look at their job from the perspective of the client, it can only benefit both sides.

The Contract Participants

It is important to know those that participate in the legal arrangements we call insurance policies.

The Insurer

The organizations that issue the policies are called insurers or issuers. They must be formed to administer insurance plans. They might be corporations, partnerships, or syndicates of individual underwriters. The ability to insure effectively depends upon a large number of people who are acquired by insurers, often through sales representatives called agents. This group of people may be referred to as the field force. The agents may be either employees or independent contractors. Often insurers hire management people to provide any needed training and supervising they feel necessary, but this is not always the case. Many insurers offer very little training or supervision. In this case, agents are responsible for acquiring any training or extra knowledge that might be necessary to appropriately represent the company’s products.

The Insured

In order for a policy to be sold someone must agree to pay for it. The person who buys the policy is called the insured. There may be more than one insured on the same policy;
Dollars and Sense

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in business insurance this usually applies to the company itself (the entity or group named as the insured). Individuals buying personal policies are more likely to have more than one insured named in the same policy. A company may, however, have more than one type of risk or multiple locations covered under one policy. The term “insured” is not always used. Other terms that may better apply in some cases are policyowner, certificate owner, subject, beneficiary, claimants, or master policy owner. For practical purposes, insured merely means the person, property, or entity that is covered by the policy.

**Insurance Contract**

Since insurers deal in promises a legal document is required. That legal document is the insurance contract or insurance policy. These contracts define the promises made by the insurer to the insured. They define the exact circumstances under which the insurer will pay and the amount that will be paid. Lawyers must prepare the contracts so there is necessary legalese involved. Since lawyers do not always agree, even though one set of lawyers may write the contract, it is not unusual for another lawyer or group of lawyers to contest the meaning. One might believe that the insurance company would be the determining factor since their lawyers wrote the contract, but that is not necessarily the case. Since it involves a contract, the courts must often decide how payment is due under the contract (policy). Even if the intent of the original policy is misstated in the contract, the word of the contract prevails (or how the courts decide the contract reads).

There is an industry joke: How many lawyers does it take to write an insurance policy?

**Answer:** 3; one to write the policy, one to dispute it, and a third to decide who is right.

Of course, developing a policy is not just the job of an attorney. It also involves analysis of a specific risk and the number of people or companies that risk involves. There are technical and economic considerations in this process. Rates and restrictions must be applied in a way that would make the insured risk profitable for the company and applicable to enough people or companies to make the issuance of such a policy worthwhile. These decisions are made by underwriting specialists who take their job very seriously. An error can cause the insurer severe financial problems. Some of the specialists involved might include engineers, statisticians, physicians, meteorologists, and economists.

**Underwriting and Rating**

The success of an insurance policy depends upon the equitable distribution of cost among those participating in the risks, which are the insureds. Underwriters classify and rate each loss exposure to maintain a semblance of equity among the policyholders. For example, a business that manufactures brooms and wants to insure against burglary will be charged a rate comparable to other similar manufacturers. Premium costs will vary...
based on the probability of the burglary occurrence (location of the business is often a major factor) and the probable severity (what does he have that would be expensive to replace and likely to be stolen?).

To avoid adverse selection, it is necessary to have a large number of policyholders that want to insure against the same risk. Even so, the insurer may not be able to insure all that wish to be insured against the loss. Following the principles of insurance requires skill in the selection of applicants. Underwriters must refuse some because the likelihood of loss is too high. In some high-risk geographical areas it can be very difficult to obtain insurance at all. The incidence of burglary is just too high for insurers to want to issue policies. Or, the underwriters might choose to issue a limited amount of policies in a given area to limit the amount of risk they assume. Highly concentrated exposures run counter to sound underwriting principles. Additionally, underwriters may refuse an applicant due to the physical nature of the property or the moral character of its owner. In some industries this would be viewed as unethical, but in the insurance industry it is the premise on which underwriting is based. They are legally allowed to discriminate when issuing insurance policies.

**Finance**

Insurers are financial institutions; they collect, accumulate, and distribute funds. The nature of insurance requires that they be expert handlers of money. Some liability claims, for example, take years to settle. Insurance companies must invest large sums of money to insure that when claims are settled, there are sufficient funds to pay claims. As a financial institution, insurers have a significant effect on our economy.

The courts have determined that insurance affects the public interest. Much of the insurance regulation in our country has to do with protecting the public. In fact, public regulation affects nearly all aspects of the insurance industry. In nearly all cases, legislation has to do with financial aspects of the industry and how that affects the consumer. Anytime incompetence or dishonesty is involved in an insurance transaction, it affects the consumer in some way.

**A Public Interest**

The concept of a business having a “public interest” is not new. It originated in 1676 with the British jurist Lord Chief Justice Matthew Hale. It took an additional 200 years, however, for the U.S. Supreme Court to establish first that a business was affected with the public interest and then apply due process. In this case, the Court affirmed the state’s right to regulate when a public interest existed. Under the Court’s ruling, when people (a business) operate in a manner that involves the public, that grants the public an interest in the operation of the property or business. Therefore, the people or business must submit to control by the public for the common good. Such control was held to be a legislative
question rather than a judicial one, which would have involved due process. Therefore the courts cannot substitute their judgment for the legislature on a regulatory policy under the guise of due process.

How does an individual know if their business has a public interest? According to the Court, there is a public interest when the action or product affects the community at large. Obviously, insurance products do affect the community. The Court says a public interest extends to any industry that needs to be controlled for the good of the public. Since insurance products affect those insured financially, regulation of the industry was certain to happen.

Insurance is regulated from the beginning of the process to the end. The formation of insurers, a company’s liquidation, policy provisions, rates, expense limitations, valuation of assets and liabilities, how funds are invested, and agent licensing are all regulated by either the federal or state governments. Regulation is sometimes more intense for some forms of insurance than it is for others. For example, anything to do with the senior marketplace tends to receive greater focus because it is perceived that the elderly are more vulnerable. Regulation will vary from state to state and each agent must know their own state’s requirements. This is not optional. When an agent receives their license they are, from that point on, legally required to know and fully understand their state’s laws and follow them appropriately. As the saying goes “Ignorance of the law is no excuse.”

**Key Person Insurance**

A business operation often has one or several people who are vital to the smooth operation of the company. In some cases, loss of a key person could actually cripple the company temporarily.

Good insurance planning is necessary in all business functions, but loss of key personnel may be critical to the company. The objective of business life and health insurance is either to maintain a business as a going concern or to retain the values of the business interest for the benefit of the estate following the death (or even disability) of the owner, stockholders, or other key people. Insurance is often used to protect the surviving members of the business where the loss or disability of a partner, stockholder or key employee could:

- Adversely affect who controls the company,
- Dissolve the business entirely, or
- Adversely affect the company’s value.

In a closely held business, numerous relationships exist that must be considered. The deceased’s family must be financially protected, the business must be able to continue to
operate (assuming others wish to do so), and there must be sufficient funds to operate effectively. The death or disability of the owner in an individual proprietorship, or one of the owners in a partnership or a small corporation, or of a key employee calls for major financial adjustments, some of which will require up to a year or two to fully complete. Without adequate funds the disabled person, the deceased owner’s estate, the position of survivors, or a combination of these, may be adversely affected. Certainly careful planning is required, which may require the skills of a business attorney. It is necessary to have legal agreements to ensure that those most able to control and run the company are able to continue doing so without interference from family or other associates that may desire control. It is unlikely that this could be accomplished without the use of insurance.

**Buy-and-Sell Agreements**

A Buy-and-Sell Agreement (also known as a Buy-Sell Agreement or a Purchase-and-Sale Agreement) is a legal document used to protect the interest of a deceased or disabled member, while also protecting the interest of surviving or healthy members. It is a contract that provides a positive market for the interest of the deceased or disabled person and a guarantee to survivors of its purchase at a reasonable price with the funds available for payment within a reasonable length of time. It is a form of “business continuation” contract.

The exact details of buy-and-sell agreements will vary based on the needs of the parties involved. It will also vary based upon the type of company or business organization involved. The names of all parties will appear in the agreement and the purpose of it will be specified in legal terms. The buy-and-sell agreement may specify the purchase price in dollars or it may simply state a specific formula to be used to arrive at a purchase price. For example, in the case of real estate a fair purchase price today may not be fair in twenty years. Therefore a formula would be stated, such as an official appraisal price by a specified type of appraiser. All parties must legally commit to the plan for the purchase of the interest of the deceased or disabled associate. The method of financing does not have to be through a life or disability policy, but that is a common way of doing so. When insurance is used, the method of financing by use of life or disability income insurance is set forth and provision is made for changing the amounts of insurance, when necessary.

It is important to note that there are usually provisions for changing the amounts of insurance in buy-and-sell agreements. This would especially be necessary for a change of position within the company. For example, a disability amount of $2,000 per month may be adequate when the contract was designed but ten years later it would be inadequate based on the person’s contributions to the business. Therefore, it would be necessary to upgrade the policy to the monthly amount contributed by the owner or employee.
Beneficiary arrangements determine whether the proceeds are to be payable to a trustee who will carry out the transfer or payable directly to the person who, under the agreement, must acquire the business interest of the deceased. A disability income policy is most likely to be payable directly to the person who was disabled while a life insurance policy may be payable to the heirs, to the company, or to the person who will be buying the deceased’s interests. There are many details involved in such a transaction, such as debts and the rights of termination, withdrawal, or amendment. The agreement has important benefits for estate tax purposes if it is properly executed. It will set the taxable values of the business interests for the estate, which may prevent delays in probate. Life and health insurance policies are filed with the agreement. Details are given as to the disposition of the insurance on the life of the surviving associates, as are the rights and privileges under the policies used during the lifetime of the insured. The ownership of the contracts may be by the business firm, by the individual partners, or by a trust, depending on the particular business needs or situation.

It cannot be stressed enough that a well drawn up buy-and-sell agreement is worth whatever the attorney may charge. A poorly drawn document is a waste no matter how little was charged. The carefully drawn agreement, implemented with life insurance, precludes misunderstanding and provides that the interest of a deceased or disabled associate will be purchased at a fair price. Life and health insurance can be used to make this financially possible at the time of need.

**The Key Person Principle**

The principles underlying key person life and health insurance for one or more individuals of particular value to the company are primarily the same, regardless of its legal form. The objective of key person insurance is to insure the loss of services caused by the death or disability of a vital employee and to provide resources with which to secure a successor in a competitive market. The insurable value may be determined by estimating the portion of the profits for which the key person is responsible, the cost of replacing and retraining an individual to step into the shoes of the key person, or the investment that might be lost by the firm. The life and health insurance purchased to cover these costs may be payable to, and be paid by, the organization that would be affected by the loss. The premiums are not typically deductible, but at the death of the key person the proceeds paid to the organization are not taxed as income either.

**Insurable Interest for Life Insurance**

Even though the life insurance contract is not one of indemnity, it still requires that there be an insurable interest between the policyowner and the person insured. An insurable interest is only required at the time of purchase, not at the time of death. Therefore, it is
possible to maintain the policy even after the key person is no longer “key” to the company’s smooth operation.

The doctrine of insurable interest is broader in the field of life insurance than in any other field of insurance. Some state statutes apply and court cases vary considerably. Generally speaking, however, so far as a person’s own life is concerned, there is no monetary limit. In other words, if people are purchasing life insurance on themselves they may purchase whatever amount they desire. Since suicide is excluded in policies for a specified time period, the policy would not pay if the insured killed him or herself in the early policy years. As a result, it is not necessary to limit the monetary amounts of the policy. Additionally, the courts have held that every person has an insurable interest in his or her own life for any dollar amount.

To establish insurable interest in other relationships there must be pecuniary (financial) interest in the continuance of the life of the insured. In some cases, this interest is obvious. For example, the financial interest between a husband and wife is presumed since they both contribute to the relationship. Actual pecuniary loss resulting from the death of an insured, as well as the expectation of future contributions to the business must be established in key person insurance.

A substantial amount of life insurance is written insuring the life of a partner in a business entity since a partner is obviously a contributing member of the company. Typically the proceeds, should the person die, are paid to the company but they may also go to surviving partners if it would mean a financial loss to them personally. Some key person policies are set up to enable the surviving partners the ability to buy out the interest of the deceased from their family members or beneficiaries.

**For example:**

Tyrone and Aaron have established an insurance agency together. Each of them contributes by making business decisions, but also by the policies they write. When they formed the company, they decided that half of the commissions on each policy written would be given to the agency to further future growth through advertising, office help, and general overhead (rent, utilities, insurance, and so forth). Although this was a general agreement between them, there is no written requirement. Therefore, if one or the other of them died, their beneficiaries would inherit the full commission renewals that are generated. Therefore, unless the remaining partner can manage sufficiently on their own, it may be wise to purchase key person insurance on each of them for the benefit of the other.

Some employees are considered key to the continuance of the company. In the case of employees, insurable interest is dependent upon the value of the employee to the business. Any employee who could be easily replaced would not be considered insurable
as a key person to the company. However, employees who occupy key positions, such as company president, executive officers, or department heads may be difficult to replace. This might especially be true of employees with specific company knowledge that would not generally be held by a new employee no matter how well educated the new person may be. If there is any doubt regarding an insurable interest, it is possible for the employee to purchase the policy rather than the employer. The employee would designate the company as the beneficiary and the employer would pay the premiums on the life insurance policy.

An employee who merely quits would not qualify the company for benefits under the life insurance policy. Only the death of the insured would trigger benefit payment.

Many small corporations are “closely held.” What is a closely held corporation? A closely held corporation is one where all company stock is held by only a few people. Typically the stockholders have common ground, such as blood relationships or bonds similar to partnerships. In fact, a closely held corporation is often called an “incorporated partnership.” Where stock is closely held the lives of primary stockholders may be insured, with the proceeds to be used to buy the stock of the deceased stockholder. This enables the deceased stockholder’s family to have immediate access to cash and it enables the company to continue without worry of interference of those who may not have the best interest of the company at heart. When life insurance proceeds are designated to purchase the rights of the deceased, there is usually some legal agreement also in place to ensure that the beneficiaries do, in fact, sell the interest to the company.

There may be non-monetary losses if an important company person dies. If non-monetary interests can be established, this is usually sufficient evidence of a financial interest (although typically both a monetary and a non-monetary interest exist). Non-monetary interest usually relates to a reasonable expectation of future financial benefits.

**Disability Insurance on Key Employees and Owners**

Companies often overlook key person health insurance. This is unfortunate since an individual is much more likely to be disabled than die. A disability is just as disrupting to the business as death since the person is still unable to perform his or her duties. In fact, it may be twice as costly to the company since the person is (1) unable to perform his or her duties, and (2) the company must hire someone to take their place. The objective of key person insurance is to insure the loss of services, not the loss of life. Therefore, it makes no difference whether the loss is due to death or disability. While we often consider disability as payment to the disabled person, in this case it may be payment to the company as well as payment to the employee that has become disabled. It could even be payment only to the company, not to the employee.
For Example:

Jose performs all the software programming for ABC Company. Jose is the only employee with the experience and technical training to provide the type of services ABC Company requires. ABC Company purchases both death and disability insurance on Jose with the business listed as the beneficiary on both policies. If Jose wishes to protect his family as well, he must purchase insurance on his own. ABC Company is only purchasing coverage to protect the business organization from the loss of his services.

In our example, ABC Company was protecting the company from the loss of Jose’s services. The company was not attempting to protect Jose’s family from his loss of income. As we have stated, the objective of key person insurance is to prevent financial loss to the company resulting from the loss of employee services due to death or disability. It is not necessarily designed to protect the family of the employee. Furthermore, it provides the resources necessary to secure a successor in a competitive market. Even if ABC Company can hire a successor to Jose, the company would still have to train him or her. During the time that the individual is being trained, he or she may not be able to properly perform the duties, which may also cause a loss of income to the company. The income provided to ABC Company from the key person insurance will replace their lost revenues.

When purchasing this type of coverage, the business must determine what their potential losses will add up to. The insurable value may be determined by estimating the portion of the profits for which the key person is responsible, the cost of replacing and retraining the key person, or the training and experience investment lost by the business entity (or all of the above). The life and health insurance purchased to cover these costs is often payable to, with premiums paid by, the organization itself. Disability premiums, like life insurance premiums, are not typically tax deductible. Also like the life insurance premiums, income realized from the disability policy would not be taxed to the company as income.

As with life insurance, when a company is purchasing disability insurance on key personnel there cannot be any doubt that the individual is vital to the organization. While some would be obvious, like the company president, others may be less evident. For example, a top salesperson with many personal clients would be vital to the company. If this individual were disabled, it could be very difficult to transfer his or her clients over to another salesperson; it might even prove impossible. The clients might end up changing over to another company entirely. Therefore, the potential financial loss to the company could be severe.

The types of people that are considered key to an organization will, of course, depend upon the business type. The agent who markets disability insurance must be aware of the many types of people that make up a company. Key employees can include such diverse
positions as officers, stockholders in small closely held corporations, engineers, chemists, researchers, positions of management, or any other person that financially affects the company and who is not easily replaced. In some cases, a key employee may not be immediately recognized. For example, consider an auto sales company that has a recognizable advertising person. If the individual that consumers frequently see on television advertisements suddenly dies, will that affect future sales?

While key person insurance traditionally is purchased for the safety of the company, it can also be used to attract and keep key personnel. Due to income taxation, an increase in salary may be less attractive than a plan that would provide a continuation of salary for a number of years following death or disability. Often a combination of coverages is provided: indemnity to the organization for the loss of the employee’s services as well as salary continuation for the employee’s dependents. Agents who market key person insurance will find a field ready for their expertise, especially if he or she is experienced in the full use of such policies. If the agent is also able to market group policies for life and health benefits, then he or she becomes a valuable member of the company’s professionals, taking a position along with their attorney and accountant.

The Small Company’s Exposure

It is easy to recognize the financial exposure large companies face when they lose key personnel. Unfortunately, this financial exposure is not always recognized in small companies. Reduced revenues are just as devastating (perhaps more so) in small organizations. For insurance agents, the key person is themselves. For the insurance agent, if he or she is no longer able to market and sell insurance policies who will replace his or her income? This is the case in all small one or two-man companies. Reduced revenues and increased medical expenses often come together when a disability happens. If no one is bringing in continued policy sales, how will the insurance agent’s family cope with his or her death or disability?

Loss of the Small Business Owner

Even when a company has additional employees besides the owner, it is likely that it is the owner that keeps the business going. Owners often supply not only business capital (such as commissions through the sale of policies) but also their time and talents. Even if another agent could be hired by the owner’s family to continue marketing policies, it is unlikely that he or she would do so with the continuation of the company as their primary concern. Therefore, it may be impossible to actually replace the owner and primary salesperson of the company. The family may be forced to sell or close the company as a result.

Over 90 percent of the business units in the United States are sole proprietorships. The sole proprietorship makes no legal distinction between the personal and business estate.
The debts of the business are the debts of the estate. The sole proprietor’s estate does not pass to the heirs until all creditors (business and personal) have been paid. If the insurance agent or his customer has not incorporated, remaining a sole proprietorship, there may be far more problems than the proprietor ever anticipated upon his or her death.

The sole proprietor’s death or disability places several decisions on the doorstep of his or her family:

1. Should the business be sold?
2. Can the business be sold? There are some types that do not readily find a buyer since the company would not be profitable once the owner has died or become disabled.
3. Can the agent’s family continue the business without his or her expertise or salesmanship?
4. Is it possible to hire individuals with the ability to carry the business forward?
5. Are there other family members both able and willing to step forward and carry on?

The primary decision is simple: liquidate the business, continue the business, or sell the business. Once that decision has been reached, other decisions will then follow, but nothing can be considered until the first question is answered. In many proprietorship companies the owner is the reason the business exists. Without him or her, the company cannot continue. Even if someone can be hired, it means an extra expense for the company since income must now be generated not only for the owner or the owner’s family, but also for the people they are now forced to hire. Revenues are likely to decline because the company’s recognition came from the owner who is now unavailable to current clients. There will be a quantity of clients that move to other companies as a result.

Sole proprietorships should plan ahead if possible by having a buy-and-sell agreement in place. Of course, this is not always possible since a ready buyer may not be available without the availability of the owner being present (since he or she is the reason the company succeeds). However, if the company could continue without the present owner, a buy-and-sell agreement may prevent some of the problems that would otherwise exist for the owner’s family. It is often a key employee that would be interested in buying the business. An insurance policy put in place would supply the funds allowing the key employee to acquire the business should the owner die or become disabled.

Of course, sole proprietorships are not the only small companies that suffer when the owner or primary owner dies. The same is true for closely held corporations and partnerships.
The legal relationship between partners is a personal one, and includes husbands and wives. While we would like to believe that all marriages are made in heaven, statistics tell us otherwise. When a married couple enters into a legal business and then experiences a divorce the business is likely to suffer financially. Few couples are able to separate personal and business relationships. A previously drawn contract specifying business relationships and ownership can be a valuable tool. When a married couple constitutes the partnership the actual business may be ran by only one of the two members. Therefore, only one may be a key employee, but both retain all legal rights and debts of the company.

Each partner is fully responsible for the business acts and debts of all other partners. If the business partners are not husband and wife, the divorce of one partner can affect the assets of the company adversely since they may be drawn into the divorce.

If one partner withdraws from the firm, the partnership is terminated. It must then be either liquidated or reorganized, with the withdrawing partner receiving compensation in some way. If the partner’s disability causes the withdrawal the firm’s resources will be severely strained. This might especially be true if the partner was a key employee. Although financial resources are strained, the partners may want to continue the disabled partner’s income at the same level. If a partner is permanently disabled, the firm may find it advantageous to buy that partner’s interest so that he or she can be replaced. The partnership is not legally compelled to liquidate or reorganize. This will be a choice of the remaining partners.

Of course, a partnership may be terminated due to death. In that event, the law requires that the partnership be either terminated or reorganized. The issues involved between liquidation and reorganization are similar regardless of whether the choice comes from disability or death of one of the partners. If liquidation is chosen the assets of the business may be sold and the net proceeds divided proportionally among the surviving partners and the heirs of the deceased partner. Seldom is liquidation a satisfactory solution. Liquidation nearly always results in loss. Additionally, the surviving partners are out of a job. Selling the business rather than liquidating it may keep the company intact, but it will not necessarily add income to the surviving partners or the deceased’s partner’s family. Each company has a specified worth, usually based on assets. However, it may provide continuing jobs for the surviving partners, which may prove to be an advantage for them. Additionally, a company sold as a continuing business is not likely to result in a loss since all debts will be sold with the company.

When a company is sold rather than liquidated, four options are usually available to the remaining partners and the heirs:

1. The heirs of the deceased’s interest may become partners in the new partnership.
2. The heirs may sell the deceased partner’s interest to an outside party.
3. The heirs may buy the surviving partners’ interests.

4. The surviving partners may buy the deceased partner’s interest from his or her heirs.

If the heirs want to become partners in the new partnership or if the heirs decide to sell the deceased partner’s interest to an outside party then the law typically requires the consent of the surviving partners. In most cases, it is felt that the most satisfactory solution is for the remaining partners to buy out the interest of the deceased or disabled partner. This prevents either liquidation or sale of the company, allows for the remaining partners continued employment, and the business can continue to prosper under continued management. If no insurance is in place for this specific purpose, two problems may prevent purchasing the deceased or disabled partner’s share:

- Price agreement, and
- Financing the purchase.

Heirs may not have a realistic picture of the worth of their inherited interest. When two or more partners exist without having specified a mutually binding buy-and-sell agreement, disagreement on the value of the partnership can continue for years. Eventually such disagreements can cause the business to fail. When buy-and-sell agreements are reached while all partners are healthy and in equal bargaining positions, such time-consuming squabbles can be eliminated. Even if the heirs feel the agreement does not provide them with as much money as they feel to be fair, the agreement is legally binding. It allows the surviving partners to organize a new partnership and continue the business.

In closely held corporations (where stock is owned by only a few people) it is important to remember how a corporation functions: usually each stock represents one vote. Therefore, a person holding 50 percent of the stock also holds 50 percent of the votes on any issue brought forth. A minority owner, usually an employee, will have little power unless his or her combined stock ownership equals at least 51 percent of the total stock issued. Where multiple employees own stock, they may be able to combine forces to exercise control, assuming all the employees can organize well enough (and agree on primary issues) to take control. Again, their combined strength would have to equal at least 51 percent of the voting stock or equal more votes than the largest shareholder. Not all stock may have voting rights. Some companies issue stock without voting rights, but normally each stock is accompanied by the right to vote.

Being incorporated does not eliminate all the problems of a disabled or deceased stockholder. It will still be necessary to determine the best course of action if death or disability occurs. If the disability is permanent, either the other stockholders or the corporation itself, if legally permitted, will have to buy out the disabled member. If there are funds available for this purpose, it should be a smooth transition. A corporation that
has a risk manager is likely to have an insurance policy in place for such a situation. Unfortunately, many small corporations do not assign anyone to act as risk manager. If no agent has suggested that such a policy be purchased, there may not be one in place.

When a shareholder dies, the corporation’s existence is not affected. Where the law protects partnerships from unwanted partners, the corporation does not have the same legal protection. The heirs of the stock can sell them to anyone they choose or they can exercise their rights of stock ownership at meetings. When just two people own all stock equally, the company can experience severe problems as each stockholder (each having 50 percent voting rights) stall all decisions affecting the business. There have been cases where the divorce of two equal owners/stockholders caused the company to fail because each party confused their divorce issues with the operation of a successful business.

When the originator and employees own a stock company, the death of the originator can lead to problems if the heirs do not have the same business sense as their deceased family member. We have seen many failed businesses after the creator of the company died leaving it in the hands of an unqualified person. If the remaining stockholders, often employees, do not have the capital to buy out the family member or do not have a buy-sell agreement setting a fair price, they may find their company slowly dying as inexperienced heirs attempt to run the company their way. Employees realize that the corporation profits are primarily the result of their efforts. When the heirs come forth to claim salaries that have not been earned or attempt to expand in ways that adversely affect the bottom line, the remaining stockholders (employees) will resent those with the majority of the stock (thus voting rights). Obviously, an investment that leads to fighting among stockholders, personal recriminations, and perhaps even legal action is not conducive to a profitable business.

**Planning Ahead for Death or Disability**

Everyone will die some day but most of us expect that to happen when we are elderly, not during our working career. Most people now purchase life insurance to protect their families but many do not purchase life insurance to protect their business organizations, whether that happens to be a partnership, corporation or sole proprietorship. If no risk manager has been assigned or if the owner of the company is not aware of the risks involved with his or her death or disability, this aspect of a company may go unprotected. Agents can play a vital role by pointing out the need to protect business rights and business income.

Disability is statistically more likely than death, yet disability remains the most unprotected risk in our lives. Probably few insurance agents have protected their family by insuring their ability to work. If agents do not consider protection for themselves and their own families it is unlikely that they are offering this risk protection to their clients. It remains one of the great untapped markets.
Insuring Entities

There are various types of insurers. Each type provides a service. It is the job of the agent and buyer to determine if one type better suits the client’s needs than another.

Private and Government Insurance

Insurance may be divided into several types. The broadest division is between private insurers and government. Government insurance will not be handled by private agents.

Private Insurers

At one time the private insurance industry was separated into three branches in the United States:

1. Life,
2. Fire and marine, and
3. Casualty and surety.

Most states allowed companies to write coverage only in one of these three branches. It was not a sensible system in the view of many. For example, automobile was split between fire insurers for physical damage and casualty insurers for liability. It seemed impractical to need two insurers to secure both types of coverage. Either type of insurer could write collision coverage.

It was not until the 1940s and early 1950s that legislation was passed allowing for full multiple-line underwriting for fire and casualty insurers. By 1955, when Ohio finally adopted the changes (being the last state to do so) an insurer could write both fire and casualty insurance in every state. It is important to note that not all states extend multiple-line underwriting to life insurance. The majority of states still consider life to be a separate line.

Before multiple-line underwriting was allowed, homeowners and business owners had to have separate policies for fire insurance and liability insurance. Additionally, a separate policy was needed for theft insurance as well as many other types of coverage. This was not only inconvenient; it was also usually more costly for the insured. Multiple-line underwriting made it possible for insurance companies to design policy forms that cover the major property and liability exposures under one contract.
With multiple-line underwriting private insurance was reduced from three to two major branches:

1. Life and
2. Property-liability.

Either life insurers or property-liability insurers may write health insurance. Most often we consider health insurance as part of life coverage, but that is not necessarily the case.

**Life Insurance**

Life companies write three types of coverage: life insurance, annuities, and health insurance. As we know, life insurance is designed to insure the premature death of another or provide business protection when a major participant dies. Life insurance provides money for the named survivors or heirs of the insured. It may also be purchased as a means of covering the expenses leading up to death and burial costs.

Annuities are the opposite of life insurance. Where life policies pay when a specified person dies, annuities are designed to provide income *prior to death*. In effect, an annuity is a means of liquidating the estate by paying income for a specified time period or for the lifetime of the annuitant. Not all annuities are liquidated prior to death; statistically, the majority of annuities are not. Despite this fact, they were designed to do so. Annuities are used for many purposes. They have become a very popular means of saving for retirement and other life goals. In fact, many state lotteries use annuities to pay the winners.

Health insurance provides money to cover in full or part the costs of health care. Depending upon the policy, the individual receives reimbursement for the costs of doctor visits, hospitalization, prescription drugs, outpatient treatments, surgery, and many other items relating to illness and injury of the insured.

**Property and Liability Insurance**

There are five types of coverage written by property and liability insurers:

1. Physical damage/loss;
2. Loss of income and extra expenses due to physical damage to property;
3. Liability;
4. Health;
5. Surety.
Physical damage or loss coverage protects the insured against loss of or damage to owned property. This would include such things as direct loss from fire, windstorm, and theft. Loss of income and extra expense coverage provides protection for insureds from income loss and extra expenses incurred due to damage to their property or the property of others. Liability coverage protects the insured against third-party claims for bodily injury or property damage caused by negligence or imposed by statute or contract. This would include such things as automobile liability, workers’ compensation, and contractual liability insurance. Health insurance written by property-liability insurers is the same as that written by life insurers. Surety (often referred to as suretyship) allows parties to offer a financial guarantee of their honesty or their performance under a contract or agreement. Fidelity, construction, and bail bonds are examples of surety coverage.

Government Insurance

Either the state or federal government may write government insurance. Additionally, it may be either voluntary or compulsory, depending upon the insurance being discussed.

Voluntary Government Insurance

Voluntary means that an individual has the choice of participation. The federal government writes crop insurance, military personnel life insurance, bank-deposit insurance, savings-and-loan insurance, securities investor protection insurance, crime insurance, mortgage and property improvement loan insurance, Medicare insurance, insurance against foreign expropriation, and backup programs written in cooperation with private insurers for coverage against perils of flood and riot in qualified areas, and for writing of surety bonds for small minority contractors. In all cases, since it is voluntary, no one is required to participate in these policies. Several states also offer varying types of voluntary coverage. Again, since they are voluntary, no one is required to participate, although some types of bank loans would not be possible without proof of insurance (so, in that respect, they may be thought of as compulsory).

Compulsory Government Insurance

Compulsory means that participation is required. Compulsory government insurance is required of the masses and we usually call this type “social insurance.” It may be written by either the federal or state governments. The best-known government insurance program is Social Security, which provides income in retirement, following a qualified disability, and for qualified survivors of deceased covered workers.
In March 2010 President Obama signed a national health care insurance bill. Typically government insurance is compulsory; in this case citizens can opt out but they may face a penalty for doing so, depending upon their personal circumstances.

Some states underwrite workers’ compensation insurance while others use private insurers. Several states operate monopolistic state funds for workers’ compensation, so no private insurance is allowed. The states typically make these plans compulsory. Workers’ compensation is required in most states, even when private insurers are allowed to compete for the business, in some cases with the state itself.

Some states have made automobile liability insurance compulsory. This does not mean that the state provides such insurance; merely that drivers are required to purchase the coverage in order to legally drive their vehicle.

Mutual Companies

Along with stock insurers, mutual companies also assume liabilities in their corporate capacity. Unlike stock insurers, which are operated for the sole benefit of their stockholders, mutual companies are controlled by their policyholders. However, just as many stockholders do not actively participate, neither do policyholders. Therefore, the so-called “control” may be more theoretical than real.

There was originally much doubt as to whether or not a mutual company could survive. It was thought that policyholders were less likely to successfully operate a corporation. In fact, mutual companies have enjoyed a great deal of success, although that success may be more of a tribute to the company managers than to their policyholders. Few purchasers of insurance are interested in running the insurance company. They are more interested in the premium rate, the claims history, and the benefits they will receive. Few care what type of organization the insurer is.

Most mutual insurers write insurance under the “assessment plan.” Assessment mutuals usually confine their business to specific types of property in limited areas and do not compete in the broad marketplace. Many mutual companies do not employ insurance agents, writing business instead directly out of the home office for the benefit of local residents.

Non-assessable mutuals operate similar to stock companies. They utilize agencies or direct writing systems. This type of mutual company is growing in numbers. Under most state laws a mutual insurer may issue non-assessable policies provided it has a surplus over all liabilities equal to the capital and surplus required of stock insurers writing the same class of business. Even though there are fewer non-assessable mutuals than there are assessment mutuals, the non-assessable write the majority of business.
Assessment Mutuals

Assessment mutuals are most active in the fire insurance field and operate principally in one of two ways:

1. Some charge only a small cash premium intended to meet expenses and cover small losses. They require policyholders to give the mutual their premium notes. Payment would be demanded if losses and expenses exceeded the cash premiums.

2. Some follow a plan of not requiring premium notes. Rather they charge a cash premium estimated to be adequate and then levy assessments if losses are higher than expected.

Under assessments, insurance may be furnished on the deposit of a cash premium. There is also an agreement that in case losses and expenses exceed income, the balance is to be collected through the assessments levied on the members (the insureds). The maximum assessment liability for both assessment and non-assessment mutuals for members is usually fixed by the laws of each individual state or by the charter and bylaws of the insurer. State law dominates, if different than the charters and bylaws.

So, who sets up mutual insurers? In theory, nearly anyone can. From a practical standpoint, it tends to be organized by a group with a similar goal. Often this is done by farmers or by property owners in towns and small cities in order to secure insurance at the lowest possible cost. How does one begin such an undertaking? Usually arranging insurance for the original founding members starts the business. After officers have been elected and the organization legally perfected, the business is entrusted to the care of an elected secretary. Since this is a new startup business the officers (including the secretary) may have other jobs that support them financially. In fact, the officers may even be volunteers, working for the insurance business without pay. This keeps expenses down. Limitation on the risks and amounts to be accepted is usually left to the discretion of the board of directors or an executive committee.

Depending upon who is speaking, the fact that mutuals operate in restricted districts is either an advantage or a disadvantage. It all depends upon one’s viewpoint. Due to their local nature, mutual insurers eliminate much of the moral hazard normally associated with insurance. When a company is small and owned by the policyholders there is likely to be a conscious effort to minimize risks that would possibly end up in a claim (costing the company money). Members know each other. This makes it easier to avoid over-insuring. It also makes fraudulent claims very difficult to achieve. Since the company is small and local, policyholders tend to have a higher moral code when dealing with their neighbors and business associates. It is much easier to feel a large, distant insurance company has lots of money to give in questionable claims.

There is a down side to this. Writing insurance on a restricted number of risks also constitutes an element of danger since it loses sight of the unrelenting application of the
law of averages. Writes the author of Property and Liability Insurance: “So long as the loss record of the locality is sufficiently low and uniform, a small mutual may prosper, but on the advent of several losses at about the same time, there may be trouble. The system of assessments providing for such contingencies, while fine in theory, might sometimes fail because of the difficulty or impossibility of collecting the assessments.” Such insurers are not always required by state or other regulating authorities to maintain surplus funds. Even so, there is an obvious tendency shown to keep a sizable ratio of surplus to coverage. In addition, history has shown the companies tend to use scientific valuation of liabilities, which helps to keep mutuals in business. Many of these companies have done far more right than their counterparts that issue stocks. In fact, the oldest insurance company in the United States, the Philadelphia Contributionship for the Insurance of Houses from Loss by Fire, established in 1752, is a mutual fire insurer.

While laws vary, some states discourage mutuals from operating in large cities. There may even be laws forbidding it. States do so because they recognize the necessity for the mutual insurers to protect their insured members against catastrophic losses. Operating in large cities may have the tendency to increase the likelihood of catastrophic losses since buildings are side-by-side and face additional types of threat. Some states merely limit the mutuals’ activity to insuring the less hazardous risks of dwellings, farm buildings, and stores within given districts. In nearly every state, the amount of insurance written must be backed by specifically stated amounts of cash premium (often 25 percent).

When a mutual company manages to spread over one or more states, it is referred to as a state mutual company. A state mutual insurer assumes greater risk since it no longer is made up of neighbors and friends who know each other. When this advantage disappears so does much of the protection from fraud and misrepresentation. The moral hazard increases. The company may also now have to rely upon agents for soliciting business. The selections of risk is now removed from the home office and placed on the judgment of their agents (who may or may not have the company’s best interest in mind).

For the consumer’s protection, a number of states have passed laws with special reference to the organization and operation of such mutual insurers. The number of applications for insurance that must be in hand before the company is considered “viable” is usually much larger for state mutuals than it is for local mutual insurers. The class of business that may be accepted by state mutuals is carefully limited in certain states, whereas in others a limit is placed on the amount of insurance that may be written on any one type of risk. State mutual companies find that the services they are allowed to render as a whole are limited.

Mutual insurers may operate similarly to a stock company if they wish to. If they choose to, they will charge an advance-premium intended to be sufficient to enable them

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3 P. 569, 4th Addition
to meet all of their disbursements for losses and expenses while accumulating a surplus. If the mutual insurer happens to earn a profit, the directors of the mutual insurer may announce a dividend, which is paid to all their policyholders. Again, the policyholders are the owners. On the other hand, if the insurer suffers a loss and has not qualified to issue non-assessable policies, the policyholders could be assessed, usually an additional premium. This would not usually happen, however, since the surplus would be used to offset the loss. The right to assess another premium is an element of strength, though. It means that the company is not limited to using the surplus, since it has the right to assess an extra premium from its members. Mutuals can shift to the non-assessable plan when they have accumulated sufficient surplus to qualify under the applicable state laws.

Non-assessable Mutuals

Many mutual insurers only issue non-assessable policies. Under these policies, the policyowners cannot be asked to pay anything in addition to their initial premiums if adverse experience happens. These companies usually follow the business methods of stock companies and maintain large surpluses to cover claims. Their premiums are typically higher because they operate like a stock company would. Although non-assessable mutuals are numerically smaller, they write more business than do the assessment mutuals.

Conversions

It is common for mutual companies to convert to stock insurers. Between 1930 and 1995 approximately 70 mutual property-liability insurers did so. While there are many varying reasons for doing so, some of the reasons include:

- The ability to offer an entire financial package
- Flexibility in products and operation procedures
- To obtain additional capital
- To form a holding company
- To join or develop more complex company structures
- To offer their policyholders tangible evidence of ownership
- To attract and keep top management personnel.

There is no doubt that it is more difficult for a small or even middle-sized company to operate amid the giants of the industry.
Reciprocal or Inter-Insurer Associations

Reciprocal exchange or inter-insurer (also called inter-insurance) associations is a type of cooperative insurance. All policyholders insure each other. Therefore, each policyholder cooperatively insures the next. Each policyholder is also an insurer, as contracts are exchanged on a reciprocal basis.

It must be noted that the reciprocal exchange is not a mutual insurer in the legal sense. That’s because the individual policyholders assume their liability as individuals, not as a responsibility of the group as a whole. Reciprocals are not incorporated either, as a mutual company typically is. Rather reciprocals are formed under separate laws as associations.

The funds held by a reciprocal are the sum total of individual credits held for the account of individual subscribers. These subscribers are required over a period of years to accumulate reserves representing a multiple ranging from two to five annual premiums before underwriting earnings, if any, are returned in cash. A separate account is maintained for each subscriber. Out of this is paid only his individual share of each loss and expense. Beyond that, the reciprocal usually can levy an assessment up to a multiple of premiums paid, such as ten times, but the liability of each subscriber is definitely limited. Reciprocal insurance is quite distinctly an American development.4

In its pure form, reciprocals are still operating in the United States. In fact, there are only around fifty to fifty-five reciprocals in operation. Most of these are small companies. The larger ones include the Farmer’s Insurance Group based in Los Angeles, the Automobile Club of Southern California, and the United Insurance Services Automobile Association based in San Antonio, Texas. Each company writes more than $500 million of private passenger auto liability premium annually. Farmer’s Insurance Group, a multiple-line company, writes total premium in excess of $8 billion.

The majority of business is written by reciprocals that are not performing in the pure form. These companies deviate in a number of ways. The companies are mutual in the sense that all the other members insure each policyholder. The members are represented by an attorney-in-fact who has been given the power to manage the affairs of the organization subject only to such restrictions as may be stated within the terms of the powers of attorney or the organization. The liability of each insured is fixed.

Like all things, reciprocals can be either good or bad, depending upon the situation. Opponents of this type of organization point out:

1. The elements that could be advantages are often not implemented which eliminates the argument for using reciprocal or inter-insurer associations.

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2. The attorney-in-fact often has too much control, and profits personally from that control.

3. The possibility of high assessments on the participants.

Those that favor reciprocals state the following advantages:

1. The cost of operating a reciprocal is limited to the attorney’s fees. For this to be an advantage the amount of pay he or she receives must be controlled in some manner.

2. Any premium savings will be refunded to the policyholders.

3. The volume of business is assured through the self-interest of the members, which should minimize the need and cost of seeking new policyholders.

4. Assessments may be limited. Liability for a possible catastrophe loss can be reduced through reinsurance elsewhere.

The bulk of reciprocal insurance is written by inter-insurance associations whose characteristics have been modified to some extent. The modifications often include the lack of separate accounts that are maintained for the members. There may be no proration of expenses or losses by the insured. Additionally, no individual may have any claim to any portion of surplus funds. Surplus funds become the property of the organization. Most of the reciprocal companies issue non-assessable policies. Those that do not issue non-assessable policies typically limit maximum possible assessments to no more than one annual premium.

When the characteristics of a reciprocal change so too do the avenues of marketing. Some write automobile, life, and other lines in addition to fire insurance. This significantly changes the description of the marketing company.

**Stock and Mutual Underwriting**

Underwriting is a major element in the insurance business. Whether it is for a life insurance policy, a fire policy, or a long-term care policy, the underwriting often determines how the company continues and whether or not they show a profit.

Stock and mutual insurers might organize into underwriting groups for the purpose of insuring special classes of property along with their normal insurance business. Although there can be many reasons why they do so, it is often to insure a unique or especially hazardous type of risk. It may also be done when there is a heavy concentration of values involved, or specialized services are required.
Some types of risks require the use of **syndicates**, who handle the insurance of aviation and marine risks, cotton and oil properties, and other similar risks. Syndicates are distinguished by the management of the group, which makes all underwriting decisions within the framework established by the board, independent of individual member-insurer influence. The participants accept their share of all the lines that are written by the group office.

**Factory Mutuals**

Some mutual companies were organized with a special purpose in mind. Typically these organizations limit their insurance protection to a specific type of business, such as lumber, logging, grain or milling, or drug manufacturers. At one time these were known as **class mutuals**. They wrote insurance only for a specified occupation or class in which they had specialized knowledge. Often the objective was lower premiums or certain forms of coverage. Today these specialized companies are known as **factory mutuals** and they now tend to write much broader coverage.

Factory mutuals began in 1835 and emphasized loss prevention through a cooperative effort of the policyholder and the company. The factory mutuals supplied inspection services and engineering advice, backed up by a comprehensive research program.

Today’s factory mutuals have broadened the type of risk they cover to include commercial property, public and educational institutions, and large-scale housing units. To be eligible a property must be of substantial construction, properly designed to minimize hazards pertaining to its class, equipped with automatic sprinklers (where applicable), and with high-grade management.

The factory mutual system consists of: three mutual companies, one wholly owned stock insurance subsidiary, and the Factory Mutual Engineering Corporation. The Factory Mutual Engineering Corporation provides inspection, adjustment, appraisal, and plan service for all the companies. Working closely with the Factory Mutual Research Corporation, it carries on basic research into the physics and chemistry of combustion and heat transfer, and the Factory Mutual Test Center, located near Providence, Rhode Island, makes it possible to duplicate industrial and storage hazards in full-scale tests. Recently prevention has been given special consideration through personnel training. This training begins with a commitment to property protection and reduced loss by top management, with training flowing down through the levels of company employees.

Factory Mutuals require their insured members to pay a large deposit premium, which is several times the yearly cost. At the end of the policy period, deductions are made for substantial loss operation services, other expenses and actual losses paid, and the balance is returned to the insured. There are no agents for the company; contracts are written using special representatives. These representatives are stationed at branch offices.
throughout the United States and Canada. They are almost entirely graduate engineers,
with loss prevention being one of their basic functions and part of their responsibilities.
The insurers do usually accept, on a brokerage basis, business from independent agents.
A negotiated commission is paid in such cases.

Factory mutual companies are characterized by their large deposit premiums, insurance
for large and high-grade industrial and institutional properties, and an emphasis on loss
prevention. Factory mutual forms provide coverage (at a single rate) for fire, windstorm,
explosion, sprinkler leakage, riot, civil commotion, malicious mischief, sonic boom,
vehicle and aircraft damage, radioactive contamination, and volcanic eruption and molten
material. Boiler and Machinery Insurance, in the same amount as the other property
insurance, are also underwritten by Factory Mutuals.

Superior Agents and Brokers

Every agent would like to think he or she is superior in his or her profession. When it
comes to business insurance only those with specialized knowledge or training should be
recommending products. Major errors may be made by agents who mean no harm.
These individuals are not intending to cause their client any financial loss, but that can
happen when the agent is not as experienced or educated as he or she should be in the
products they are recommending.

Some areas of insurance are now mandating suitability training in products in an attempt
to prevent agent errors. Insurers market in a variety of ways, but most of them use
agents, especially when it comes to business insurance. Each state has thousands of
licensed agents and brokers representing hundreds of commercial insurance companies.

Although there is a distinct difference between an agent and a broker most consumers
think they are synonymous and interchangeable. The only direct writers are those
companies that do not use agents at all, but rather sell directly through the mail or
through association programs. However, captive agents and independent agents are the
two groups most likely to be involved in marketing business insurance. Captive agents
sometimes represent themselves as direct writers, but this is not technically true since an
agent is involved.

We have sometimes heard that an independent agent is more likely to be able to assist
the consumer when claims are disputed, since they represent the client rather than the
insurer. In reality it is unlikely that any agent, captive or independent, has much clout to
move a claim forward. It is true that an independent agent can still write business with
other companies if he or she is having a dispute with one of the insurers they have
licensed with. However, it is unlikely that any one agent has enough business with the
insurer to truly make any difference in a claim dispute. Most disputed claims go to
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arbitration or litigation whether the agent agrees or disagrees with the insurer’s stance on claim payment.

Captive agents are likely to have a contract that mandates their alliance to the company rather than the client. Even so, claims that are disputed will not be settled by the agent, captive or otherwise. The state statutes will determine some, but most will be settled between the policyholder and insurer, independent of the agent.

For the policyholder, the bigger issue should be the stability of the writing agency (second, of course, to the stability of the insurer chosen). While the insurer might assign a replacement agency if the agency closes, most policyholders want to know with whom they are dealing with or may have a special relationship with their agent.

One determining factor might be the size of the agency, although that does not necessarily guarantee financial stability. Some businesses may want to select a specific agent they feel secure with whether that happens to be a one-man or one-woman operation or a large agency with whom they are employed.

A necessary consideration is the availability of products for the type of business being insured. The size of the business being insured can determine the type of insurance product needed. It is necessary, therefore, to know the size of the business prior to setting up a meeting between owner and agent. This is true not only for the business owner but for the agent as well. There is no point in wasting each other’s time if the agent is unable to deliver what the business wants to buy.

National insurance brokerages are the largest of the independent agencies. These brokerages usually have multiple offices and are located in the majority of the states. They may even have affiliations overseas.

Next in size is the medium to large-size independent agencies. While there may be some variances, these agencies usually write a significant amount of commercial business. The large-size agencies place business with fifty or more insurance companies and is fully automated. Sometimes they have special arrangements with insurers that benefit the business owner. This might include such things as the ability to bind the coverage or the ability to commit the insurer to insure the risk. Larger companies tend to be fully computerized tying directly to systems in some insurers.

From our point of view one of the most important factors is the expertise of the agent. As we said, too many agents attempt to advise in areas for which they are not qualified for. The Buyer’s Guide to Business Insurance by Don Bury and Larry Heischman states: “The insurance industry has tried to encourage its members to involve themselves in continuing education programs to show a commitment to the industry and to professionalism.” Unfortunately state mandated education has not necessarily yielded educated agents. It has been our experience that those who wish to be educated will be
with or without state mandates. Those who are not interested in broadening their knowledge will not do so, even when legally required to.

Some agents pursue special designations in insurance. Some are harder to achieve than others, but all of them demonstrate an interest on the part of the agent in higher education. Since the difficulty in achieving these designations varies we do not wish to make any comment on which one is best. It is our view that any additional education is worthwhile, though some are certainly better than others.

1. Chartered Property and Casualty Underwriter (CPCU) – ten parts.
3. Accredited Advisor in Insurance (AAI) – three parts.
5. Chartered Life Underwriter (CLU) – ten parts.

“Parts” pertain to the sections of education that must be completed in order to obtain the specified professional designation. Agents may obtain additional information from the groups that offer this education. There may be additional designations besides those listed here. Each will require some amount of education.
Insurance Trusts

A trust is a legal agreement under which money or other assets are held and managed by one or more people for the benefit of another person or group of people. Different types of trusts, including the insurance trust, may be created to accomplish specific goals. Each kind of trust may vary in the degree of flexibility it has and the amount of control it offers.

The common benefits that trust arrangements offer include:

- Providing personal and financial safeguards for family and other beneficiaries;
- Postponing or avoiding unnecessary taxes;
- Establishing a means of controlling or administering property; and
- Meeting other social or commercial goals.

Creating the Trust

Certain elements are necessary to create a legal trust, including a trustor, trustee, beneficiary, trust property, and trust agreement.

The person who provides property and creates the trust is called the trustor. The person may also be referred to as the grantor, donor or settlor.

The trustee is the individual, institution, or organization that holds legal title to the trust property and is responsible for managing and administering those assets. The trustee is usually designated by name, but a trustee may be appointed by the courts when applicable (in the case of minor children, for example). In some cases, the trustor can also be the trustee, which typically is the case for revocable living trusts. In revocable trusts, the owner of the assets may also manage them and have full access to them. As a result, there is seldom any tax advantages connected to revocable trusts. At most, they may delay the payment of taxes.
Trusts may have two or more trustees that serve together as a committee for the benefit of the testator and his or her beneficiaries. There may also be an individual and an organization named to act as co-trustees. Separate trustees may also be named to manage different parts of a trust estate. For example, one person may manage the assets for a minor beneficiary while another manages the minor’s personal care. When minors are among the beneficiaries this is often recommended to protect the interests of the child.

The **beneficiary** is the person or organization who receives the benefits or advantages (such as income) of the trust. In general, any person or entity may be a beneficiary, including individuals, corporations, associations, charities, or even units of government (although it is difficult to imagine anyone donating to the government).

To be valid, a trust must hold some property or assets. Because there are so many so-called “opportunities” to establish a trust, it is not unusual for a trust to be created, but never funded. This might happen because the testator used a do-it-yourself format that can be purchased or found on the internet. It may also happen because a salesperson, collecting a fee, sets up the trust but leaves funding to the testator. Although the salesperson’s intentions may have been good, if the testator fails to move any assets or money into the trust it remains unfunded or empty. When this is the case, the trust never becomes valid.

**Trust property** may include any asset, such as stocks, real estate, cash, a business or insurance policies. Trust property may include both real and personal property. Trust property may also be called the “trust corpus,” “trust res,” “trust estate” or “trust principal.” Trust property might include some future interest or right to future ownership, such as the right to receive death proceeds from a life insurance policy. As previously stated however, if property or assets are not transferred appropriately to the trust it cannot accomplish anything.

The **trust agreement** is the legal contract between the trustor and trustee. It generally contains a set of instructions for the trustees and may even hold instructions for the beneficiaries in some cases. It will provide duties, obligations, and personal instructions from the trust creator (trustor). It may state the purpose of the trust, the property to be held and invested, and how the proceeds may be used or distributed to beneficiaries.

Most of us would assume a trust must always be written. While trust agreements are typically written, they may also be oral agreements or even just implied. The trustor usually has considerable latitude in setting the terms of the trust. To be enforceable, some types of trust assets need to be in writing, however. For example, a trust involving an interest in land must be in writing.
Types of Trusts

Many kinds of trusts are available. Trusts may be classified by their purposes, by the ways in which they are created, by the nature of the property they contain, and by their duration. Trusts are often classified as either living trusts ("inter vivos" trusts), or testamentary trusts.

**Living trusts** are created during the lifetime of the trustor. It is always important to use professionals that specialize in trusts when using trusts to accomplish specific goals. Property held in living trusts are not normally subject to probate (the court-supervised process to validate a will and transfer property on the death of the trustor) although it may be necessary to list the trust assets in court proceedings. Not all states will require the trust be disclosed, so the individual should seek legal counsel in their state for specifics. When trusts do not need to be disclosed it is usually because they are not subject to probate or estate taxation. Therefore, they do not need to be listed in the court record and confidentiality is maintained. Trusts are widely used because they allow the trustor to designate a trustee to provide professional asset and distribution management.

In some cases, living trusts allow income to be taxed to the listed beneficiary resulting in income tax savings for the trustor. However, income earned by a trust established for a beneficiary under the age of 14 may be taxed at the beneficiary's parent's tax rate. The transfer of property to a living trust may also be subject to gift tax. As always, consult your attorney or accountant for details.

**Testamentary trusts** are created under a will and must conform to the statutory requirements governing wills in the individual’s state of residence. Testamentary trusts become effective upon the death of the person making the will and are commonly used to conserve or transfer assets. The will requires part or all of the decedent's estate to transfer to a trustee who is charged with administering the trust property and making distributions to designated beneficiaries according to the provisions of the trust.

Before the trust property becomes subject to the testamentary trust, it will normally pass through the decedent's estate. When the estate is probated, testamentary trust assets could be subject to probate. Trust assets are also potentially subject to estate and generation-skipping transfer taxes at the time of the decedent's death.

A testamentary trust gives the trustor substantial control over the estate’s distribution. Testamentary trusts can provide for a child's education or delay receipt of property until the child is old enough to appropriately handle wealth. Some types of trusts may exempt property from death taxes until the later death of the trust beneficiary. A generation-skipping transfer tax may still apply however.
Living trusts can be either revocable or irrevocable. The trustor has the right to change the terms or cancel a revocable living trust. Upon revocation, the trustor resumes ownership of the trust assets.

A revocable living trust is typically used when the trustor does not want to lose permanent control of his or her assets. There may be varying reasons for this. Perhaps he or she is unsure of how well the trust will accomplish their goals or is unsure of how he or she wishes to distribute property upon death. The trustor may not feel secure putting assets into any vehicle that takes away personal control.

Revocable trusts do provide specific benefits, however. With a properly drafted revocable trust, the individual may:

1. Add or withdraw some assets from the trust during his or her lifetime;
2. Change the terms and the manner of administration of the trust; and
3. Retain the right to make the trust irrevocable at some future date.

The assets in this type of trust will generally be includable in the trustor's taxable estate, but may not be subject to probate, depending upon the state of residence and the exact terms of the trust document.

An irrevocable living trust may not, as the name indicates, be altered or terminated by the trustor once the agreement is signed – it is irrevocable. Irrevocable trusts have two distinct advantages:

1. The income may not be taxable to the trustor; and
2. The trust assets may not be subject to death taxes in the trustor's estates.

These benefits will probably be lost, however, if the trustor is entitled to:

1. Receive any income;
2. Use the trust assets; or
3. Otherwise control the administration of the trust in any manner that is inconsistent with the requirements of the Internal Revenue Code.

Since an individual may revoke or amend their will at any time prior to death, a testamentary trust may be changed or canceled too. Revisions can be made by drafting a new will or by using a codicil that is attached to the original will showing any changes or additions. It is not wise to use too many codicils since that can simply become confusing. If multiple changes occur, it is best to simply draft a new will. All codicils must be executed in the same manner required for wills.
The trust must be explicit regarding its revocability or irrevocability. Otherwise, the trust will likely be legally considered irrevocable.

**Trust Establishment**

Depending on several circumstances and state requirements, trusts may be established orally, in writing, or by conduct (intent). Trusts typically involve a number of legal concepts relating to ownership, taxes, and asset control. Although anyone can establish and execute a trust, usually attorneys or accountants assist in explaining options, considering contingencies, and preparing documents.

Unfortunately unqualified persons often assist individuals or even urge individuals to establish a trust (usually for a fee) when it is not financially advantageous. Having an unnecessary trust is not likely to cause great problems (unless some assets are placed in trusts that should not be), but the cost of drafting a trust can be high. Such trust fees are wasted if the document is unnecessary, unfunded, or poorly written. When a trust is an advantage for the individual, several things should be considered, including:

- The individual’s personal situation, including age, health and financial status;
- Family relationships and the family's financial circumstances;
- Personal financial data, such as personal property, real estate holdings, securities, and other property - as well as the tax situation and any debts or obligations;
- The trust purpose, such as financial goals, beneficiary goals, and what the trust is intended to accomplish;
- The type of trust, and how versatile or flexible the individual’s plans are.
- The amount and type of property it will contain;
- The length of time the trust will last;
- Beneficiaries and their specific needs;
- Any conditions the beneficiary must first meet to receive trust assets (such as attaining a certain age, marrying, being employed and so forth);
- Alternatives for disposing of assets in case the trust conditions are not met or circumstances change; and
- The trustee, and the conditions or guidelines under which he or she will function.

Dependency exemptions, capital gains and losses, income, gift, estate and generation-skipping transfer taxes also should be considered when planning certain types of trusts. Just as agents recommend with life insurance policies, it is wise to state contingents in the trust document. This would include trustees and even beneficiaries.
Like wills, once the trust is established it should be reviewed periodically. Life changes, such as marriage, divorce, the birth or death of children, and any other major changes in life may require trust changes. If the trust is irrevocable, there should be a provision written into the document that allows changes under specific conditions.

**Trust Situs (Location)**

Most trustor’s probably establish the trust in their resident state, but it can also be established in the trustee’s state, if different. When deciding where to establish the trust, remember that each state has different laws governing the operation of trusts and trustees' powers. If the trustor changes his or her state of residence, the trust location can also be changed in most cases. This is referred to as a “change of situs.” A location change may also be desired due to tax reasons. Whether or not the move can be made, and how the move is accomplished, will be dictated by each state's laws.

**Duties and Obligations of a Trustee**

A trustee, whether an individual or institution, controls legal title to the trust property and is given broad powers over maintenance and investments, unless restricted within the trust document. Trustees are required to follow all state and federal laws regarding their ethical and legal responsibilities. In general, a trustee must:

- Follow the express terms of the trust instrument;
- Act impartially, administering the trust for the benefit of all trust beneficiaries;
- Administer the trust property with reasonable care and skill, considering both its safety and the amount of income it produces;
- Maintain complete records and any accounting requirements of the assets; and
- Perform taxpayer duties, such as filing tax returns for the trust and paying required taxes.

At no time may the trustee use any trust principal or income for his or her own benefit or profit. The trustee must administer trust assets solely for the designated beneficiaries. The trustee may not borrow or otherwise use assets in the trust, including selling his or her own property to it, or using the trust assets as collateral for personal debt.

It is important to consider the potential trustee's competence and experience in managing business and financial matters prior to selection. Naming a trustee does not necessarily mean he or she is available and willing to serve. This should be discussed with the desired trustee prior to naming them in the trust document.
Individuals and companies (such as banks) may serve as trustees. There are advantages and disadvantages to both. For example, a bank, usually offers specially trained managers to provide administrative, counseling and tax services that an inexperienced individual may not have. Banks will also be available for many years, without worry that illness or relocation would make the duties difficult or even impossible for a single individual to continue. Most banks charge a fee for trust services. Some banks may not accept small trusts having less than a specified amount of assets. In fact small trusts may not do well with a bank since the fees charged may eat up too much of the available trust assets over time.

Relatives, family friends or business associates may serve as trustee without charging for their services, but they are less likely to have the experience an institution would have. Even so, this person is likely to add a more personal touch that would not be available through banks or other institutions. If the beneficiaries are minors, this personal touch may be an advantage since the relative or friend will have special knowledge that the bank would not have. However, since these individuals are unlikely to have the skill and experience necessary to properly manage some trust assets, it may be important to write the trust with allowances for hiring those with such skills to assist the trustees.

The Life Insurance Trust

Insurance trusts take various forms. Some are business insurance trusts, which may be used to protect the “key men,” proprietor or partners of a business. Personal insurance trusts involve no business interests. Personal insurance trusts are generally intended to provide management of insurance proceeds and protect the estate from some forms of taxation. Insurance trusts may be revocable or irrevocable, and various types of agreements are available to accommodate an individual's circumstances and desires, or the requirements of a business.

One form of insurance trust is the **life insurance trust**. This trust, similar to a living trust, is created to receive proceeds payable under a life insurance policy. It is normally established to exclude proceeds from taxation in the decedent's estate. A life insurance trust can also be used to provide a vehicle for continued management and distribution of insurance proceeds for a beneficiary who may need assistance in those matters, such as a minor child or disabled adult. Sometimes life insurance trusts are used to manage estate assets for an adult who has not displayed financial maturity, spending recklessly or refusing to accept normal adult responsibilities.

A life insurance trust is an irrevocable, non-amendable trust which is both the owner and beneficiary of one or more life insurance policies. Upon the death of the insured, the trustee invests the insurance proceeds and administers the trust for one or more named beneficiaries. If the trust owns insurance on the life of a married person, the non-insured spouse and children are often beneficiaries of the insurance trust. If the trust owns
“second to die” or survivorship insurance that only pays when both spouses are deceased, only the children would be beneficiaries of the insurance trust.

An **Irrevocable Life Insurance Trust**, known as an **ILIT**, is a powerful estate planning tool. An ILIT is a special type of trust designed to own life insurance policies and to protect the proceeds from estate taxation. Because it is irrevocable, no changes may be made once it has been established.

Since the technical language required for an ILIT is designed to meet strict requirements of the Internal Revenue Code, it is very important to obtain services or advice only from professionals who have the knowledge, skills, and experience in creating life insurance trusts. Insurance agents should never offer such services or advice unless they are qualified to do so by training and experience.

**Life Insurance Trusts and Federal Estate Taxes**

While most middle class estates are not subjected to the federal estate tax, those estates valued in excess of $3.5 million in the year 2009 were. To compensate for these taxes, many people purchased life insurance. However, the life insurance they bought often added to the tax it was meant to cover.

When a person buys life insurance, he or she intends to provide financial security for their beneficiaries upon their death. They may inadvertently also leave their family with additional taxes.

<table>
<thead>
<tr>
<th>Year</th>
<th>Tax Rate</th>
<th>Exemption Level</th>
</tr>
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<tbody>
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<td>2009</td>
<td>45%</td>
<td>$3.5 million</td>
</tr>
<tr>
<td>2010</td>
<td>0%</td>
<td>Tax Repealed</td>
</tr>
<tr>
<td>2011</td>
<td>55%</td>
<td>$1 million</td>
</tr>
</tbody>
</table>

In determining estate values, include the fair market value of all assets. The fair market value is the amount the asset would sell for on the open market. This includes real estate, stocks, bonds, all retirement accounts and usually the proceeds from any current life insurance policies. To keep the life insurance proceeds out of the taxable estate, the insured must not also be the owner of the policy. The beneficiary cannot be listed as the estate either – a person or other entity must be named. Who should own the life insurance policy? If the spouse owns the policy, the proceeds may not be included in the estate, but the amount left over will probably be taxed when the spouse dies. This is a primary reason an irrevocable life insurance trust is used.
Death benefits from life insurance policies are not subject to income tax, but they are subject to estate tax and inheritance tax. In 2010, the federal estate tax will disappear, but only for that year. In 2011, unless Congress takes action, the federal estate tax will return. Financial experts say that’s why precise planning is needed over the next several years - to ensure heirs get the largest inheritance possible.

It should surprise no one that the IRS doesn't like these trusts, and have successfully challenged some of them in court. That doesn’t mean they can’t be used, but life insurance trusts and Crummey trusts must be correctly used to be effective. Recent cases have approved their use when correctly drafted.

Unfortunately, too few people understand that it is best not to own your own life insurance policy. As such, if you are purchasing a new policy, you should not be designated as the owner or the applicant. You should first set up the trust, and have the trustee apply for the policy on your life.

The trust must be drawn with attention to every detail. Life insurance should be just one of the permissible investment vehicles rather than the sole purpose of the trust. It must clearly state that the trustee has all ownership rights to the policy.

Finally, make sure that the trust has appropriate language that will enable you to make tax-free gifts to the trust, so that the insurance premiums can be paid. Only those with proven experience in trusts should draft a life insurance trust.

When it comes to the irrevocable life insurance trust, doing things right means paying attention to detail and following all of the rules. Doing things wrong means that Uncle Sam could take a chunk of the life insurance proceeds. Therefore, the additional expense of preparing such a trust is worth the cost.

**Disadvantages of Life Insurance Trusts**

To recap, a life insurance trust is a trust that is set up for the purpose of owning a life insurance policy. If the insured is the owner of the policy, the proceeds of the policy will be subject to estate tax when he dies but by transferring ownership to a life insurance trust, the proceeds will be completely free of estate tax. The proceeds would be exempt from income tax either way.

There are several drawbacks to such an arrangement however, including:
1. **Policy beneficiaries cannot be changed.**

The insured must give up the right to change the beneficiary of the policy (the trust itself is the beneficiary). The trustee alone has that right, and the insured cannot serve as trustee of his own life insurance trust. The insured does designate the beneficiaries of the trust, but the designation cannot be changed once the trust has been set up. Therefore, the insured lacks flexibility to deal with changed family circumstances such as a new spouse, adopted children, or newly born children. This may be circumvented to some extent by stating beneficiaries less specifically, such as “all surviving and legally adopted children equally.”

2. **Loans may not be made from the policy.**

The insured can no longer borrow against his or her policy. If the trust allows him to borrow against the policy, he will be deemed the owner for estate tax purposes, losing all tax advantages.

3. **Existing policies cannot be transferred to the trust unless the insured lives for at least 3 more years following the transfer.**

If the insured transfers an existing policy to a life insurance trust and dies within the next three years, he will be treated as the owner of the policy and it will be taxed in his estate. Even if he survives another three years, he will have made a taxable gift in the amount of the cash value of the policy, which may be preferable to having the entire face value subjected to estate taxes. If the life insurance trust takes out a new policy on the insured's life, however, the insured will never be deemed to own the policy. No cash values will have built up yet, so no taxable gift is made.

4. **The life insurance trust must be irrevocable.**

Once the trust is set up and funded, the insured cannot get the policy back. If he or she becomes uninsurable, the trust will be the only source of life insurance.

5. **Premium payments may use up your estate tax exemption.**

If the policy has not yet endowed, premiums must still be paid without using up all the estate and gift tax exemption. If securities are transferred to the trust so that the trustee will have income with which to pay the premiums, the full value of the securities will be a taxable gift. If cash is transferred to the trust each year to pay premiums, each transfer will be a taxable gift. It may be possible to exempt these premium payments from gift or estate taxes by setting the life insurance trust up as a Crummey Trust. Then each premium payment can be sheltered by the annual gift tax exclusion.
6. You must find or hire a trustee.

The insured cannot serve as their own trustee of the life insurance trust. He or she will have to find or hire a third party trustee. Many banks and trust companies offer reduced fees for life insurance trusts because they involve essentially no investing decisions, but there will be fees of some sort.

Despite these possible drawbacks many people find the tax saving potential of life insurance trusts worthwhile. It allows the trustor to remove a significant asset from the estate that probably would not be accessed during life so is unlikely to affect day-to-day living or financial quality of life. In the process it ensures that the life insurance proceeds go 100% to the beneficiaries, not to the federal government.

Providing Financial Structure

The benefits of life insurance may be maintained while avoiding estate taxes on the life insurance proceeds through an irrevocable life insurance trust. An ILIT is a trust that is separate from the individual’s primary estate plan. It is irrevocable, meaning the testator cannot change it once it has been created. Creating such an irrevocable trust requires certain steps, including:

1. Meeting with a financial advisor or attorney who is knowledgeable in trust planning and procedures. No trust is right for everyone, but many people can benefit from this type of trust. The meeting is to determine if it is right for the particular situation.

2. If an ILIT is right for the goals of the investor, a trustee and beneficiaries must be selected. The investor might use his or her life insurance agent, accountant, or any appropriate person as the independent trustee. The investor’s attorney creates the trust documents to reflect the individual’s decisions and plans.

3. Then the individual signs the trust document and the trust is created at that point. The trust is a separate legal entity that contains two important things: the instructions for what the trust creator wants done with his or her property held in the trust (life insurance and cash) and a delegation of authority to the trustee and successor trustee to carry out specified instructions.

4. Finally, money is placed in the trust on behalf of the beneficiaries. The trustee deposits the money in the trust checking account. The money is exempt from federal gift and estate taxes up to the annual exclusion amount and is treated as a gift to each beneficiary.

The proceeds of life insurance policies provide cash when beneficiaries may especially need them – after the primary wage earner has died. That same cash also faces federal
estate tax. Life Insurance proceeds are exempt from income tax, but they are subject to estate tax where it applies.

For those who live in a state subject to estate tax, life insurance proceeds can help pay that tax. Having life insurance in the estate provides cash, but it is taxable cash. The very life insurance that helps pay state taxes is itself taxed. The more life insurance there is the more tax is due. Obviously it would be better for the insured and his or her beneficiaries if taxes did not reduce the life insurance’s value.

Avoiding Estate Taxation

By creating a life insurance trust, heirs avoid some estate taxes following the insured’s death. The life insurance trust takes over the responsibility of making premium payments and, after the insured’s death, the distribution of the policy proceeds to the heirs. Estate tax only applies when the insured is responsible for paying the premiums. By creating the trust, the policy is no longer part of the estate so no estate taxes apply to it after the insured’s death.

It is wise to hire an attorney that specializes in estates to draft the life insurance trust. He or she must be someone who is responsible and reliable because the trust could be in existence for several decades. The attorney could also serve as trustee, but he or she will charge for those services. Banks also usually have a trust department, but they will also charge a monthly or annual fee for their services. The insured must purchase a life insurance policy to put into the trust unless he or she already owns one, which could then just be moved into the trust. Once the trust is set up nothing can be changed. If changes are made after the trust has been set up, the government might see this as an "incident of ownership," meaning the policy is still in the insured’s name and therefore subject to estate taxes. In addition, if the policy was purchased prior to the trust creation it must be there for at least three years to avoid estate taxes. Many professionals feel it is best to buy a new policy after the trust is created.

The insured needs to make a gift worth the first year's premium to the trust so the trustee can make the policy payments. After the first year, the insured would make gifts to the trust in the name of the beneficiaries approximately 60 days prior to the policy premium’s due date. If the payments are made as "present interest gifts" it may be possible to deduct the gifts per beneficiary in that tax year, so the payments would not be considered taxable gifts.

If an old policy is brought into the trust, it may be considered a taxable gift – a good reason to buy a new policy rather than use an existing one. The insured may be able to use his or her unified credit to avoid taxes, but only if the unified credit has not already been used.
The Annual Exclusion

To qualify the gift for the annual exclusion, the beneficiaries must have the right to withdraw the gift each year. The trustee must give all beneficiaries notice of the gift and their rights to withdraw it. If the beneficiaries do not withdraw the gift, the trustee uses the gift to purchase life insurance on the trust creator, and gift in subsequent years to pay the annual premiums.

This cycle of gifts, notices, and premium payments continues each year. When the insured dies, the trustee collects the insurance proceeds. If all the requirements of annual contributions, notices, and so forth have been met, those proceeds will not be part of the insured’s taxable estate.

The Final Payoff

The trust language gives the trustee authority to use the funds (life insurance proceeds) in the ILIT to purchase assets from the trustee or the executor in the primary estate or to distribute the funds to the named beneficiaries following the trust creator’s instructions.

Although the procedures required to make a life insurance trust effective may seem complicated they are designed to meet specific criteria of the Revenue Code and of IRS rulings, including court decisions interpreting and applying the code. Once the trust and insurance policy are in place, however, the operation of the trust is a simple matter. An ILIT is certainly a better alternative than paying estate taxes to the government.

An individual may only create an ILIT while he or she is (1) considered competent and (2) able to qualify for the underwriting a life insurance policy requires, unless there is an existing life insurance policy that can be used. If either of those requirements does not exist, the ability to create an ILIT and to reap its substantial benefits is gone. Estate planning typically requires time to accomplish whatever goals are desired, so it is always wise to identify and implement goals as early as possible and appropriate.

This type of trust cannot be revocable, and the insured cannot retain any right to trust income. To ensure the tax advantages are retained, it is important that the document be properly drafted. The tax rules in this area are quite complex, so professional legal assistance may be helpful in the preparation of such a document.

Charitable Trusts

A charitable trust is also called a “public trust” because it benefits, immediately or eventually, members of the general public through charitable organizations or directives.
It can offer many tax advantages to the trustor not available to other private trusts. Unlike private trusts, it can be established to last indefinitely. There is no stated termination date.

Charitable trusts can offer great flexibility, if properly drafted. They can be complicated if the goals are very specific, but they need not be. Charitable trusts can be flexible if they are written with broader language. For example, a trust that will donate only when specific circumstances exist will be less flexible than one that donates broadly. Charitable trusts must be carefully drafted to receive the tax treatment desired.

**Charitable Remainder Trusts**

A commonly used charitable trust is the “charitable remainder trust.” This type of trust allows the trustor to give a future interest in their asset to charity, while keeping an income stream for him or herself or for another named beneficiary.

A trustor may specify that a certain portion of the trust income be distributed to a non-charitable beneficiary for a certain period of time, with the charity to receive the money or property thereafter (upon the death of the non-charitable beneficiary, for example).

While offering an immediate tax deduction for the charitable contribution, the charitable remainder trust may also lower the estate taxes. To qualify for a charitable deduction, specific formats must be followed, and the charitable beneficiary must meet standards specified by the Internal Revenue Service.

The amount of the charitable deduction is based on complex tax laws that consider such factors as the beneficiary’s age, the property’s value, and the expected income from the trust. Because of the detailed legal concepts and changing IRS regulations, it is advisable to consult a lawyer when considering these trusts.

Charitable trusts are an excellent planning tool for maximizing income during the client's life and benefiting charities at death. The trustor avoids capital gains taxes on appreciated assets; the charity receives the assets sometime in the future. The only loser is the IRS.

A charitable remainder trust makes payments to the trustor for a term of years or for life, depending upon how the trust document is written. At the end of the term, the property that remains in the trust is transferred to a predetermined charity. In a nutshell, the trust functions much like an annuity retirement plan, with the two added benefits of capital gain tax avoidance, and a charitable income tax deduction. Like an annuity, once the asset is transferred to the trust, the trust pays an income to the trustor for life and the life of their spouse, if applicable. The payment is a predetermined amount (either a variable or fixed percentage). When both spouses finally die the charity gets the assets that were
transferred to the trust. No value was lost to the capital gains tax, plus a tax deduction was received on the present income tax return. The heirs may not actually lose anything despite the donation to the charity if other estate planning techniques are used in concert with the charitable remainder trust.

Not everyone will benefit from using the charitable remainder trust. Usually, if the individual has highly appreciated property (real property or stocks for example) and/or are in a position where he or she will owe the government taxes upon their death because of their total estate values, then a charitable remainder trust makes sense.

Once it is determined that such a trust is appropriate, the trust must then be created. The provisions of the trust will either set up what is called a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT). The unitrust provides a variable income based upon a percentage of the charitable gift, and is usually paid on a quarterly basis. The annuity trust is a fixed amount per month.

Once the trust is created the trustor transfers the gift into it. Depending on the asset, it can be as easy as signing a quit-claim deed to the trust's name. This transferred property is then used to generate the income for the "donor". The trust then takes this asset or property and uses it in the most appropriate way, which may mean converting it into liquid assets with greater income producing ability.

Since many people do not want to diminish the inheritance their children and grandchildren would receive, other estate planning must be done. This can usually be accomplished by using an irrevocable life insurance trust. Some of the monthly income generated by the charitable trust is used to purchase a life insurance policy on the client's life, which is then placed into an irrevocable life insurance trust. When the client dies, the policy replaces the approximate value that was given to the charitable trust.

The steps taken would include:

1. The client transfers the appreciated property to the trust. Sale of the property would greatly reduce the asset’s value due to the capital gains tax. The real property is instead transferred to the trust. The client gets an income tax deduction for this "gift" to the charity, although the charity will not get the asset until the client dies.

2. Next the trust takes the real property and sells it so it can make investments to produce income for the client. The trust does not have to pay capital gains tax, so it can use the entire sale amount to invest.

3. The trust then pays a monthly income to the client for his life (and his spouse’s life, if appropriate) out of these invested funds.

4. When the client dies, the remaining amount in the trust goes to the specified charity.
As is typically the case, there are both advantages and disadvantages to using charitable trusts.

**Advantages:**

- Provides tax benefits. Charitable Remainder Trusts provide for a present income tax deduction for federal income tax purposes.

- Avoids capital gains taxes. A Charitable Remainder Trust allows for the sale of appreciated assets by the trust without paying federal income tax on the gain. State and local taxes may also be avoided. This results in more money available for investing and, ultimately, a longer income stream.

- Achieves tax-free accumulation of earnings. Income from Charitable Remainder Trusts are taxable only to the extent of income distributions made to beneficiaries. Undistributed capital gains or earnings in the trust accumulate tax-free.

- Provides tax-favored income. The avoidance of capital gains allows the trustee to reinvest the entire principal amount generated from the gifted asset.

- Allows for diversification of investments. A Charitable Remainder Trust that sells the appreciated assets avoids immediate capital gains taxes. The proceeds from the sale can then be reinvested in a more diversified or higher-yielding income-producing investment portfolio.

**Disadvantages:**

There are two disadvantages to a charitable trust:

The payments to the income beneficiary are limited to the amount set forth in the trust instrument. No additional distributions can ever be made to the income beneficiary, no matter what the need may be. The individual can never get to the assets that were placed in the trust, only to the monthly income that is generated. As with an annuity that has been annuitized, payments only are accessible.

When the income beneficiary dies, the trust property passes to charity rather than to children or other beneficiaries. For many, this seems like an insurmountable problem, but it should not be if a life insurance trust is also created and appropriately funded. If the life insurance trust is created, intended beneficiaries get the same amount of assets, only they receive it in cash and without any estate taxes taken out.
Bypass Trusts

A bypass trust is a long-term planning device. If an individual leaves property to someone in the form of a bypass trust, that property will not be subject to estate taxes but it will still be taxed in the estate. A bypass trust is particularly useful for spouses who plan their estates together. By leaving property to each other in bypass trust form, they can guarantee that the property will only be taxed once between the two of them.

To effectively save taxes, a bypass trust must follow certain rules laid out by the IRS. Suppose the will sets up a bypass trust for one’s husband, and the wife dies first. In order to keep the trust from being subject to estate tax when the husband dies, the wife’s will must place the following conditions on the trust:

1. The husband's power to access the trust during his lifetime must be limited.

   The husband cannot have unrestricted rights to withdraw principal. He may, however, have the right to withdraw principal to provide for his health, education, maintenance, or support. He may also have the right to withdraw up to $5,000 of principal per year for any purpose, or 5% of the total principal, whichever is greater.

   He may also be granted the right to all of the interest and dividends earned in the trust each year. He can also be appointed as trustee. As trustee, he would have full discretion to decide whether principal is needed for his "maintenance" or "support." This allows the trust to be very flexible.

2. You must limit your husband's power to distribute trust assets upon his death.

   Except as provided above, the husband cannot have the right to give the trust assets to himself, his creditors, his estate, or his estate's creditors. He can be given the right to name specific persons in his will who will succeed to the trust upon his death. For example, he could be authorized to leave the trust to any of his nieces or nephews, or to divide it as he pleases among his children. On the other hand, the wife could specify who gets the trust next leaving him no discretion.

   The bypass trust can be very flexible but it is critical that it be carefully drafted. The IRS has specified the words that may be used in a bypass trust, and if those words are not duplicated perfectly the trust might not be excluded from tax in the second estate. Even the slightest drafting error can cost hundreds of thousands of dollars in taxes. Therefore, only an experienced tax law attorney should ever draft a bypass trust.
Crummey Trusts

Many people wish to make lifetime gifts to their children in order to save estate taxes. As long as a parent gives his child no more than allowed per year, the gifts will be entirely excluded from gift or estate taxes. Unfortunately, many parents realize their children are not equipped to handle large cash gifts due to immaturity or circumstances. Parents may appoint themselves custodians of the funds preventing access to the money until age 21, or in some states 18. However, reaching legal age does not necessarily mean financial maturity also exists.

In order to give the gifts, but still keep it out of the child's hands until a later age, many parents set up a formal trust. The parent then continues to make the gifts, but they are made to the trust, with the trustee investing the money. To conserve costs, the parent may even act as trustee themselves. The trust document could direct assets to be distributed to the child upon reaching a specified age. It is also possible for the trust to distribute funds in steps. Perhaps the child receives one-third when he turns 25, one-third when he turns 30, and the final third when he turns 35.

Life insurance trusts can benefit the living, too. Cash payments or "gifts" are made to the trust to be used for life insurance premium payments. It is possible to avoid paying gift taxes if the policy is in a trust. This tax loophole is called "Crummey power." A man named Clifford Crummey created a trust and transferred his assets into it. His goal was to avoid estate and inheritance taxes when he died. In 1968, the Internal Revenue Service took Crummey to court, claiming he was using an illegal tax loophole. Crummey won and established a precedent, making the trust a legally acceptable tool.

To make this work, an individual writes a check for each beneficiary as a "gift" to the trust and gives it to the trustee. The amount gifted should be no more per beneficiary than allowed to exempt it from gift taxes. The trustee then writes a letter to the beneficiaries, informing them they can withdraw the money from the trust in the next 30 days.

The depositor does not want the beneficiary to actually withdraw the funds. In order to get the gift-tax break, however, the beneficiary must have this legal right. If the beneficiary does not withdraw the money it becomes trust property. In most cases, the trustee will send part of the money to the life insurance company to pay the life insurance premium. The rest will remain in the trust and go to the beneficiaries when the trustor dies.

The annual exclusion only applies to gifts in which the recipient has a "present interest" in the gift (as opposed to a "future interest"). In order to completely avoid gift or estate tax on the money put into the child's trust, the child must have some right that qualifies as a "present interest." The child must have the right to take the money and spend it
immediately. However, the parent can place significant restrictions on this right without losing the gift tax exclusion.

If a beneficiary withdraws the money that is supposed to pay premiums, there might not be enough cash left to make the payments. Insurance policies could lapse and beneficiaries would not get the death benefit.

A Crummey Trust does not give the child any rights to the income but it does give the child the right to withdraw the amount of each gift for up to 30 days after each gift is made. Since the withdrawal right begins immediately after the gift is made, it is considered a present interest. If the child does not withdraw the gift within that 30 days, the withdrawal right lapses and the money remains in the trust until the child reaches the designated distribution age.

The parent must convince the child not to withdraw the money during those 30 days. However, even if the child decides to withdraw the money, he can only withdraw the amount of the most recent gift - not the entire trust. The parent could eliminate all future withdrawal opportunities simply by ceasing to make any more gifts. The assets in the trust remain intact and growing until distribution.

**Inheritance Tax versus Estate Tax**

An **inheritance tax** is a tax imposed on beneficiaries receiving property from a deceased individual. The tax is calculated separately for each beneficiary, and each beneficiary is responsible for paying his or her own inheritance taxes. Not all states impose inheritance taxes. States that do impose them frequently tax spouses and children of the deceased at lower rates than other heirs.

An **estate tax** is a tax imposed on the deceased's estate as a whole. The executor fills out a single estate tax return and pays the tax out of the estate's funds. The heirs will only be held liable for the tax if the executor fails to pay it.

The federal government imposes the estate tax on all citizens and residents of the United States. Inheritance taxes are a state tax and not all states have them. Many middle class Americans will owe no federal estate tax due to the allowed exemptions.

Life insurance beneficiaries will not have to pay income taxes since life insurance proceeds are exempt from the federal income tax if they are received as a result of the insured's death. The estate may owe estate tax on the value of the proceeds, however. Without careful estate tax planning, life insurance proceeds will be included in the taxable estate.
Trust Longevity

There is no specified trust life time. Each document may specify how long the trust will exist or establish no termination point at all. State laws must be considered however. For example, some state laws will not allow a private trust to continue longer than a specified amount of time following the death of a person living at the time the trust was established. Charitable trusts, however, may continue indefinitely due to the intent of the trust.

Taxes

The use of trusts can help achieve certain goals, usually asset preservation or the reduction of taxes. While trusts can offer a number of tax advantages, tax avoidance should not be the sole motivation for using them since they may not achieve the savings the trustor desires in all situations.

The laws governing trusts and their taxation are complex and subject to change. Federal and state governments have tax attorneys too and their goal is to maximize collection of taxes, not allow citizens to avoid paying them. As an example, under the Tax Reform Act of 1986, income earned in a trust having a beneficiary under age 14 will be taxed to his or her parents. This is a significant departure from prior tax law, which provided that such income be taxed to the child at his or her own tax rate, often resulting in little or no tax being due.

With constant changes in tax laws, an individual contemplating a trust for tax purposes should consult with his or her accountant or attorney to determine whether the trust can meet their tax objectives. By carefully choosing the proper type of investments within a trust, it may still be possible to accomplish tax goals, but careful planning and drafting are required. At no time should a consumer rely on salespeople without provable tax or accounting experience and skills.

Trust Fees

The cost of creating and administering a trust varies, depending on its type and duration. It is important to realize that the cost of establishing the trust is not necessarily tied to its effectiveness. The experience of the individual creating the document is especially important, so the consumer or agent should seek out those with previous trust experience. The lawyer's fees to create a trust will usually be based on the time involved in consulting with the trustor and in planning and preparing documents. Before hiring an attorney fees should be discussed. Some will charge hourly or while other may have a flat trust creation fee. Ask for an estimate or arrange a written fee agreement.
The trustee's fee typically varies with the skill and expertise possessed. Charges may be influenced by the size and complexity of the trust estate as well. This affects the nature and amount of services required, such as record-keeping, asset management and tax planning. There may also be accounting, real estate management, or other service fees. Other common charges include annual, minimum, withdrawal and termination fees.

**Trusts and Wills**

Even though a trust document of some type has been created, a personal will is still necessary. There is no situation where a will is not appropriate; any person of legal age should draft a personal will. Having a trust does not change this.

A will backs up the trust. While it may seem duplication in some areas, having a will covers any asset or contingent situation not covered under the trust.

While everyone needs a will, those with children most certainly have a moral obligation to write a will. A will is needed to appoint guardians for minor children. Trustees may also be needed to manage assets for the children’s benefit. If there is not a will, the court may appoint any guardian they feel appropriate, even someone the parents would not have approved of.

Even when there are no children, a will is still necessary. In some cases, a legally married spouse has not received the entire deceased spouse’s property – especially if there are parents or siblings wanting to inherit. Parents or siblings might inherit part of the home and become co-owners with the remaining spouse. The spouse would not be able to sell the house or other property without their permission, and vice versa. Parents and siblings can be recognized in the will or left specific pieces of property if that is the goal; a will directs property to the person intended.

Many people have heard that a living trust avoids probate, so they assume a will is not necessary. A living trust works because none of the assets are in the deceased’s name at death. If the trust creator has vigilantly transferred everything owned to the trust, the distribution of assets at death will be handled under trust law rather than probate law. In some states, such as California and Ohio, trust law is much simpler than probate law but that is not true in all states. In many states the differences are minor so, as always, it is necessary to know the laws of the domicile state. Probate is a necessary service in many cases since it identifies all involved parties (preventing fraudulent claims against the estate) and closes the financial affairs of the deceased. Insurance agents may not realize, for example, that probate closes the time period for lawsuits against the agent and his or her estate for errors and omissions claims. Trusts cannot close this possibility so even if an agent has a trust holding all assets, it may still be wise to go through probate.
Even if there is a fully-funded living trust, the distribution of assets can still be delayed if your estate is large enough to owe estate taxes. Federal law holds the trustee and executor personally liable for any unpaid estate tax. Therefore it would be foolish for the trustee of a living trust to distribute the trust assets before making sure the IRS is satisfied with the amount of estate taxes paid. The IRS will, upon request, issue a "closing letter" providing some protection to the trustee or executor, but the process of requesting and obtaining the closing letter can take a long time. When we hear of an estate tied up in probate, it is entirely possible that the probate court is not to blame at all; it may really be the fault of the estate tax system. Avoiding estate tax is very different from avoiding probate. A living trust or properly drafted will can both accomplish the same thing when it comes to estate taxes, so either document could be used.

Probate horror stories are often caused by events outside the probate system. Simply setting up a living trust to avoid probate without dealing with the other issues causing delays will not prevent an estate from suffering the expense and delay of contested heirs, assets that difficult to value, or estate taxation issues. While a well drafted trust might eliminate the primary issues, it takes very little to also draft a will. That small document may avoid many problems later on.
Annuities

An annuity is a contract between the insured and an insurance company. A lump-sum payment or series of payments is made to the annuity. In return, the insurer agrees to make periodic payments to the insured beginning immediately or at some future date. Annuities offer tax-deferred growth of earnings and do not affect current taxation status unless funds are withdrawn. If a beneficiary is listed, upon the annuitant’s death proceeds go directly to the individuals or entities listed, bypassing probate procedures. Payout options vary so it is very important to understand which payout option has been selected since some payout options eliminate beneficiary designations.

There are generally two types of annuities—fixed and variable. In a fixed annuity, the insurance company guarantees the annuitant a minimum rate of interest during the time the account is growing and periodic payments will be a guaranteed amount per dollar resting in the account. These periodic payments may last for a definite period, such as 20 years, or an indefinite period, such as the annuitant’s lifetime or the lifetime of two or more named people.

Annuity Choices

Traditional annuities offer several choices. The combination of choices made will affect the amount of funding available from the annuity at retirement. These choices include:

Joint and Survivorship Annuities

Under joint and survivorship annuities the income is paid until the last policy annuitant dies. Although the annuitants are typically a husband and wife, it does not necessarily have to be this relationship. It could be a parent and child, sisters or brothers, business partners or any number of relationships. There may also be more than two people listed as payees. Joint and Survivorship annuities are often used with married couples because retirement is a joint issue. Even though each partner may have saved separately when building up his or her capital anything that was jointly earned and saved is typically paid to both parties in retirement.

A joint and survivorship annuity can be an option with any traditional annuity. In many
cases, it is also possible to select the level of income the surviving spouse will receive. These decisions determine how much income is received while both parties are alive. Most professionals feel the surviving partner’s annuity should not drop below two-thirds of the joint annuity. It is generally estimated that the difference between supporting one person and two people is about one-third since many household costs are fixed, such as mortgages, home insurance, gasoline, and utilities.

**Guaranteed and Life-time-Certain Annuities**

The guaranteed and life-time certain annuity is guaranteed for a predetermined number of years, whether the annuitant lives for the guaranteed period or not. If the annuitant dies before the guaranteed time period ends (often 10 years, but it can be much longer), the annuity continues to be paid to the person designated as beneficiary in the policy for the remainder of the guaranteed time period. Beneficiaries would not receive life time income; only the annuitant would receive income for their life time.

If the annuitant lives *beyond the guaranteed income period*, the income continues to the annuitant only. If the annuitant dies beyond the guaranteed period, any residue capital reverts to the life insurance company; beneficiaries receive nothing. Only during the guaranteed period will beneficiaries receive any income.

**Level Annuities**

Under level annuities, the annuitant receives the same amount of income each and every month for the period of the annuity. Inflation can reduce the buying power of the income since the amount the annuitant receives each month never changes. Once the annuity is annuitized the income begins, but it is never adjusted for inflation or cost-of-living increases.

When the annuitant first begins receiving the annuity income, it will be comparably higher than what might be drawn from another annuity types. However, within a few years, due to inflation, it could be significantly less than what would have been received if another annuity type had been chosen. The drawing point is longevity since it pays to the end of the annuitant’s life, potentially paying out far more than he or she actually saved or would have earned in interest elsewhere. Therefore, it may be wise to use this type of annuity but have other types of assets as well that make up for lost value resulting from inflation and rising costs of living.

**Capital-Back Guaranteed Annuities**

Capital-back guaranteed annuities have two parts: an annuity and a life insurance policy. The annuity provides the annuitant with income and pays the premiums on the life insurance policy. This allows the annuitant to fully use the funds from the annuity for their lifetime, but still provides something for beneficiaries.
There may be double commissions if a commission is paid for the annuity and another for the life insurance policy. Usually it is possible to find such an arrangement with a single commission rather than two. While the agent is not likely to worry about double-paid commissions, consumers may prefer the lower commission base of a single commission payment.

**Escalating Annuities**

The escalating annuity increases at a predetermined fixed amount each year. The annuity may track, lead or lag inflation, depending upon its structure. With these annuities, the annuitant receives less initially compared with a level rate annuity, but the increases in annuity income will help maintain the same standard of living for the duration of the annuity. It is designed to battle lost purchasing power due to inflation.

Most life companies will permit increases of no more than 20 percent each year on an annuity with a 10-year income guarantee. Increases of 15 percent per year may be permitted on a life annuity. It takes about nine years for an annuity linked to an inflation rate of 10 percent to catch up with a level annuity. Most professionals feel this is not too bad considering how long people are now living.

**Inflation-linked annuities**

Inflation-linked annuities are linked directly to the inflation rate, increasing annually in line with the rate of inflation. Where escalating annuities have predetermined increases in income, this annuity actually tracks the rate of inflation.

**Enhanced annuities**

These annuities are offered by a few life insurance companies to people who can prove they are in poor health. While this concept goes against what insurance companies normally do, it actually makes sense for the insurer. If the annuitant is likely to die soon or has bad habits such as smoking heavily, the life insurance company is less likely to pay out benefits for a long period of time. While no one can say positively how long or short their life may be, there are factors that are strong indicators of longevity. The details of these policies vary so it is very important to see what the annuitant is gaining by purchasing such a policy.

**Annuity History**

It would be easy to assume the annuity is a modern day financial device, but they have been around for a very long time in one form or another. During the 1800s annuities even played a big role in Native Americans losing their lands to the US Government.
During this period the government enticed the Indians into trading their vast lands for trinkets and guaranteed annuities, often at rates that constituted gross underpayment. The tribes were forced into smaller areas, where their only real income was from government annuities. When the Native Americans needed additional money to purchase food and clothing, they could only buy from certain Government-approved traders, who would extend credit to the Indians. As the Indians' debts to these traders increased, the tribes were forced to sell more land to cover their loans. In one instance, the Governor of Indiana, which was then a territory, settled seven treaties in four years with First Nations in southern Indiana, Wisconsin, Missouri, and Illinois. The natives sold their land for what amounted to two cents an acre (in some cases less), paid to them in guaranteed annuities. Historians generally agree that the First Nations, in this and many other cases, were deceived in selling at this price.¹

Land treaties signed by the First Nations are, technically speaking, legitimate legal documents. They received goods, annuities, or a sum of money in return for a parcel of land. Of course, these “legitimate” (though certainly not fair) exchanges left many native people upset and confused, as they had never truly understood what they were selling. The tribes did not understand the transactions since they did not live by or use the concept of property ownership. They were likely unaware that they would no longer be able to use the land after they sold it. To make matters worse, the treaties were often negotiated under duress. Native leaders were bribed and softened up with alcohol, and when that didn't work, threats were often made to stop payments on annuities from past treaties. Whenever these strategies failed, the US government was also not averse to sanctioning militant efforts to force the Native Americans off their lands.

As time went on, a number of Native American tribes became increasingly dependent on annuity payments and so were compelled to sell more and more land to the federal government. In a span of fourteen years the Potawatomi tribe, for example, signed six land treaties, which resulted in the tribe giving up large swaths of land in Illinois, Michigan, Wisconsin, and Indiana. Instead of turning against the government, this tribe from the Chicago area became so reliant on annuities that they would do anything to protect their flow of payments. This included acting as peacemakers on behalf of the government in 1827 when their kindred Winnebago tribe from southern Wisconsin threatened to rise up against white settlers.

Annuities have been used in many ways. In the United States, all railroad employees and their families are entitled to a number of benefits under the Railroad Retirement Act and the Railroad Unemployment Insurance Act. These include unemployment insurance as well as retirement-survivor benefits, the latter of which is paid through an annuity that is administered by the Railroad Retirement Board (RRB), an independent agency of the US Government.

¹ The History Collection
Like traditional insurance companies, the RRB has field representatives to help railroad workers and their families file claims for benefits. There are adjusters who determine the validity of the claims. Calculation of benefits and processing of payments is highly automated, and the RRB also employs information technology staff to manage the various electronic systems.

The Great Depression brought about the RRB to a great extent. The railroads were ahead of other industries in introducing private pension plans. The first American railroad pension plan dates back to 1874. During the 1930s, however, serious defects in early private pension plans became magnified by the Depression, and a more suitable solution had to be found. Legislation was passed, creating a national retirement benefit annuity program for railroad staff.

The Depression highlighted how many elderly citizens had either insufficient retirement income or none at all. It was the Great Depression that gave birth to the idea of Social Security, although it did not become a reality until 1935. Railroad workers saw an immediate need for retirement benefits during the early thirties. Rather than stand around waiting for the government to offer a solution, they expanded upon and unified the existing private plans under one umbrella.

Beginning in 1934 the entire RRB system was implemented by 1937. Social Security was a reality by now, but the RRB began delivering benefits before Social Security did. The railroad retirement system still remains separate from Social Security, although the two are closely linked. A retiring railroad worker is entitled to a railroad annuity that is greater than the amount he or she would receive from Social Security. The portion corresponding to that which he or she would receive from Social Security is partially reinsured by the Social Security system. In this way, the funds are in the same position they would be in if the worker were covered by Social Security instead of the railroad program.

At one time employers wanted to provide retirement benefits to workers but this has gradually changed as costs became burdensome. Group annuities have been offered as a way to ensure the financial comfort of employees following retirement. Group annuities differ slightly from individual annuities in that the payout of a group annuity is dependent upon the life expectancy of all members of the group rather than on the individual. The administration costs of group annuity programs are usually absorbed by the employer.

Our annuity history includes use by our military. Not only were soldiers granted annuities, but their widows were often entitled to receive annuities as well. Widow’s claims exist in the form of letters sent and received between their representative and the government office responsible for issuing them.

Annuities existed on both state and national levels. In some cases, annuities were even awarded to women that served an important personal role in military campaigns. The
Annuity Museum\(^2\) has a newspaper article discussing the granting of an annuity to Molly Macauley. She participated beside her husband on the battlefield during the Revolutionary War. Military annuities were awarded for bravery and service and protected the survivors of fallen American soldiers.

Annuities have been around for over two thousand years in one form or another. In Roman times, speculators sold financial instruments called *annua*, or annual stipends. In return for a lump sum payment, these contracts promised to pay the buyers a fixed yearly payment for life, or a specified period of time. The Roman Domitius Ulpianus was one of the first annuity dealers and is credited with creating the first life expectancy table.

During the Middle Ages lifetime annuities purchased with a single premium became a popular method of funding the nearly constant wars that characterized that period. There are records of a form of annuity called a *tontine*. This was an annuity pool in which participants purchased a share and received a life annuity in return. As participants died off, each survivor received a larger payment, until finally the last survivor received the remaining principal. Similar to our modern-day lottery, the tontine offered not only financial security but also a chance to win a jackpot.

During the 18th century, many European governments sold annuities providing lifetime income, which was guaranteed by the state. In England, Parliament enacted hundreds of laws regulating the sale of annuities to fund wars, provide a stipend to the royal family, and to reward those who were loyal. In the 1700s and 1800s annuities were popular with European high society. Their popularity is not surprising since annuities could shelter the investors from many of the ups and downs experienced in other markets.

Compared to other areas of the world, annuity use grew very slowly in the United States. Annuities were mainly purchased to provide income in situations where no other means of providing support could be found. Americans were more likely to rely on support from family members. Annuities were mostly purchased by lawyers or executors of estates who needed to provide income to a beneficiary as described in a last will and testament.

Annuities finally gained some popularity due to the spreading out of American families at the turn of the 20th century. There were fewer family members available to provide care for other family members during illness or as they aged. The Great Depression was especially significant in the history of annuities. Until then, annuities represented just 1.5 percent of life insurance premiums collected between 1866 and 1920 in the U.S. During the Great Depression investors sought out more reliable investments in order to safeguard themselves from financial ruin. With an unstable economy, investors looked to insurance

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\(^2\) The Annuity Museum’s offices are located at 8 Talmadge Drive, Monroe Township, New Jersey 08831 (USA). All original documents and artifacts exhibited are owned by the Annuity Museum and are available for viewing by appointment only. To schedule a visit, call 732-521-5110 (USA, Eastern time zone).
companies as a haven of stability when few other investments appeared to have any security at all.

**Annuity Terminology**

All legal contracts use terminology specific to them. Agents must be aware of all terms and conditions in the legal contracts they sell – insurance policies and annuities. Agents must also be able to communicate well enough to explain in lay terms what these terms mean to the policyholders and their beneficiaries.

**1035 Exchange**

As specified by the tax code, section 1035(a), permits a (usually) tax-free funds transfer from annuity to annuity; the 1035 exchange excludes the transfer of funds within an annuity from one subaccount to another.

**403 (b)**

Similar to a 401(k), the 403(b) is a tax-deferred retirement savings account offered to employees of nonprofit organizations, through which contributors invest in annuities (often referred to as TSAs) or in mutual funds.

**10% Penalty Tax**

As it applies to annuities, a 10 percent IRS fee charged upon the withdrawal of pretax savings (contributions or earnings) from an annuity before the age of 59 ½.

**Asset Allocation**

In a variable annuity, asset allocation is the distribution of assets across multiple classes (such as stocks, bonds, and cash) in order to meet an individual’s financial goals in terms of risk and length of investment. Asset Allocation can reduce risk and maximize returns on the investment.

**Back-End Charge**

Fees incurred by an investor for cashing out early on a deferred annuity or variable annuity, usually within the first 7 to 10 years after investing (depositing). This is often called a surrender charge.

**Bailout Provision**

If a fixed annuity’s interest rate falls unpredictably below a rate specified in the annuity contract, the provision assures the surrender-charge-free withdrawal of all funds from the under-performing annuity account.

**Balance Inquiry**

A balance inquiry is an on-line tool allowing contract holders to check the balance of all accounts held within their annuity.
Benchmark Index
An index that measures the performance of market allocations in a variable annuity. A benchmark index also compares performance between a variable annuity and an investment portfolio. These indices cannot be invested in directly; also, in contrast to an investment portfolio, these indices do not require that transaction fees and other costs be paid by an investor. These may also be called stock or bond indices.

Beneficiary
The individual, organization, or entity that receives money upon the death of an immediate annuity contract holder. It may also include the person, organization or entity that benefits from continuing payments upon the death of an immediate annuity contract holder that has not yet received all of the guaranteed income stream for the contractual time period of the annuity.

Beta (3 year)
A percentage reflecting the relative volatility of the subaccounts in a variable annuity as compared to the market as a whole (often determined using the S&P 500). A value greater than 1 percent is indicative of volatility over the market.

Bonus Rate
The bonus rate is extra interest accumulated in the first year of a deferred annuity that is added to the sum upon which interest is calculated in later years. Also called the first-year bonus rate.

Certificate Owner
The purchaser of an annuity, whether an individual, organization, or entity.

Compound Earnings
In a deferred annuity, the reinvestment of previous interest earnings back into the annuity account.

Contingent Annuitant
In the case of the death of an annuitant prior to the beginning of annuity payments, the person who is designated to receive the payments in the original annuitant’s place.

Contingent Deferred Sales Charge (CDSC)
A fee charged to the account of a deferred annuity or variable annuity upon the full surrender of an annuity contract or upon the withdrawal of funds in excess of annuity contract limits.

Contract Owner
The purchaser of an annuity contract and holder of all rights pertaining to it. With a variable deferred annuity, this person or entity may have rights extending to making
investment decisions, initiating monetary transfer and redistribution among funding elements, withdrawal rights, and the naming of the annuitant (usually the contract holder) and any beneficiaries.

**Death Benefit**

The death benefit is a guarantee of payment of the annuity account value or a different, specified amount (such as the value of the original lump sum funding payment minus withdrawals) to designated account beneficiaries upon the early death of an annuitant or annuity contract holder, before the deferred annuity or variable annuity is annuitized (before the annuity is converted into systematic payouts). In many variable annuities the value of the death benefit increases over time, and several kinds of death benefits exist: the greater of the value of the current account or the value of the initial funding payment; rising floor, in which the insurance company provides a guaranteed minimum return, regardless of the performance of any annuity subaccounts, on any deposits; Ratchet, the greater of the values of the contract, any payments minus all withdrawals, or the contract on a given date; and Stepped-up, guaranteeing payment of the value of the annuity account as per set anniversary dates (e.g., on a yearly periodic basis).

**Deferred Annuity**

Deferred annuities feature a contract with accumulation and can be funded either through a one-time lump sum payment or through multiple payments over time. Any investment accumulates over the years with a tax-deferred status. Deferred annuities can be variable or fixed. When chosen by the policy owner payments from the annuity begin through annuitization options.

**Direct Rollover**

A monetary transfer classified as a rollover but which occurs from one investment company directly to another, often from one investment plan into another (such as from a 401(k) plan into an IRA account). Direct rollovers must be reported but are not taxed, and therefore annuitants can avoid taxation of distributions by using this method.

**Diversification**

In a variable annuity, a method that helps an annuitant reduce or avoid risk by distributing funds over multiple asset classes; for example, an annuitant could diversify by investing in stocks within different industries.

**Dollar Cost Averaging**

In a variable annuity, dollar cost averaging is the investment of a fixed amount of dollars at regular intervals. This is a financial strategy that could eventually ensure that the average cost per unit will fall below the average price or the market high; however, it does not guarantee profit or guarantee the avoidance of a loss. Investors must invest in securities on a continual basis despite any fluctuation in prices and should assure his or her ability to continue purchasing in times of low prices before using this strategy.
Effective Annual Yield
In a deferred annuity, the rate used after the daily compounding and crediting of the annuity’s interest. The effective annual yield includes any first-year bonus and can be calculated as follows: using the rate bonus, a bonus paid on the base rate by some annuities (e.g., with a 6 percent base rate and a 1 percent first-year bonus, the effective annual yield will be 7 percent), and using the premium bonus, paid upfront by some annuities (e.g., with a 6 percent base rate and a 1 percent premium bonus, the effective annual yield might be 7.06 percent).

Effective Interest Rate
The interest rate when an annuity is compounded annually. For example, with an initial $10,000 deferred annuity investment, over one year at an effective rate of 10%, $1,000 will be earned in interest. This is also called an annual effective rate or an annual effective yield.

Enhanced Dollar Cost Averaging Program
In a fixed annuity, a dollar cost averaging program providing an often higher interest rate in particular cases, e.g., for new minimum purchase payments within a limited period of time. Specified amounts are usually transferred automatically over a given time period from a fixed to an investment account.

Equity Index
In equity-indexed annuities, equity index is the index used to measure the performance of stocks or bonds selected for indexing the annuity, with an increase in performance resulting in an increase in the value of the equity-indexed annuity.

Equity-Indexed Annuities
A type of annuity offering a guaranteed minimum return rate; may also offer additional interest earnings based on the value of an equity index. The indices used for determining the value of an equity-indexed annuity are commonly well-known stock indices, such as the S&P 500.

Equity Investment Style
Within an annuity, the combination of investment types used.

Exclusion Ratio
The ratio of taxable to nontaxable proceeds in an immediate annuity payment.

Expense Ratio
The percentage of an annuity account that is paid on a yearly basis toward insurance and investment charges.
Immediate Annuity
Immediate annuities guarantee a systematic stream of income. They are funded by a lump sum payment to an insurance company. In a given annuity period, e.g., monthly or yearly, an immediate annuity provides payments composed of both the principal and any interest earnings; payments will, over time, liquidate the principal. Immediate annuities are often purchased for the purpose of providing income during retirement.

Surrender Penalty
Fee charged to a deferred annuity account for excessive or multiple withdrawals that exceed the limits imposed by the annuity contract. Upon the surrender of the entire annuity, the penalty could be assessed according to the total annuity account value.

Surrender Value
Value of an annuity account minus any surrender penalties paid, as laid out in the annuity contract.

Yield
Yield is the annuity’s rate of return. Often a percentage of earnings in relation to the annuity balance.

Annuity Basics
There are many annuity products in the marketplace. Even agents may have difficulty discerning the differences; certainly it is difficult for the annuity buyers. There are many different products available under the fixed and variable annuity headings: tax-deferred, guaranteed, inherited, equity indexed, and more. While there are only two basic types of annuities (fixed and variable) each has many sub-types and marketing names. Insurers often market their products under company names making it difficult to compare apples to apples.

Annuities are tax-deferred investment vehicles. Investors deposit their money either in a lump sum or through a series of contributions. Although annuities are marketed by many different entities, they are always placed with a life insurance company that sells annuities (the annuity issuer). The period of time the annuity is being funded is known as the accumulation phase. In exchange for investing in the annuity, the insurer promises to make payments to the investor and possibly a named beneficiary at some point in the future. When the annuity vehicle begins paying the annuitant a monthly income it is known as the distribution phase. For many investors, the distribution phase begins at the point of retirement, but that is seldom mandatory. Many annuity investors never annuitize their contract, so the entire amount continues to grow. Upon the death of the annuitant, the annuity funds would then go to the named beneficiaries. If no beneficiary was designated, upon the annuitant’s death, the un-annuitized accumulations would go to the annuitant’s estate. Of course, a beneficiary should always be listed as well as a
contingent beneficiary designation in case the primary beneficiary predeceased the annuitant.

These annuity terms generally refer to the different features that can be applied to the basic annuity product. Some of these features are great for retirees and are options recommended by the most respected financial planners in the country. Other annuity features are almost universally condemned by the same planners. Therefore, it is important to understand these options so you can determine which annuity is most appropriate for your clients.

**Choosing Between Fixed and Variable Annuities**

Perhaps the most important consideration to make when evaluating annuities is whether to choose a fixed or variable annuity. Each has its proper place, but neither is right for everyone and every situation.

Fixed annuities are typically based on fixed income products, such as bonds and once annuitized, pay a guaranteed stream of income. It is a fixed annuity because the income stream is “fixed.” The annuitant knows how much income will be received each and every month once annuitization takes place. Of course, annuitization is not mandatory and many annuities are never annuitized. Even so, the insurer’s intent when selling these products is to provide a stream of income – for the annuitant’s life if that is the payout option selected.

The fixed annuity guarantees the investor a specified income – no matter what – which makes fixed annuities a good choice for retirement financial planning. Guaranteeing an income during retirement is a common financial planning goal. It is important, however, to note that there will be no adjustments in the annuity income for inflation or rising costs of living. The specified amount continues to be the same regardless of these factors unless steps have been taken to counteract this situation. The investor can elect to pay extra for an annual Cost of Living increase or inflation protection as an option on the annuity contract.

Variable annuities are typically based on mutual funds and pay a stream of income that moves up and down with changes in the value of the underlying funds. A variable annuity is a riskier investment for retirement since there are no guarantees as to monthly income.

Many financial retirement planners recommend fixed annuities since retirement is generally a time in life when risk must be avoided. There are no wages and little time to make up potential losses once the investor enters retirement. Fixed annuities are less risky and provide a more reliable income stream. Some planners might recommend primarily fixed annuities with a smaller amount invested in variable annuities if the specific situation allows this without putting the retiree in a precarious situation.
Choosing Between a Lifetime Annuity and Term Annuity

Lifetime annuities are annuities that pay an income stream when annuitized for the remainder of the investor’s life – no matter how long he or she lives. In fact, depending on how long the investor lives, a lifetime annuity could pay a higher sum over the investor’s lifetime than originally invested in the annuity. The opposite could also be true – the investor could die before recouping their investment. Because of this, many annuity products offer premium protection – insuring that the investor or their heirs will receive back at least as much as was invested. It all depends upon the payout option chosen. Payout options should never be selected until full understanding exists.

Lifetime annuity payout options are a good choice for those who want to guarantee additional income beyond an existing pension or Social Security payments. The annuity does not need to be annuitized at any particular time so the retiree can hold funds in the contract until additional income is needed or desired. Once annuitized, the income stream will not change so it is important to annuitize only when the income is actually needed.

Term annuities result from selecting payout options that pay the investor an income stream for a specified period of time that he or she selects (versus lifetime income). Term and lifetime annuities are actually the same annuity product – the selected payout option is what results in one or the other annuity product.

Most annuities have several withdrawal or annuitization options. Most annuities will allow the investor to withdraw portions of the earned interest once or twice each year without actually annuitizing the annuity contract.

There are several annuitization options:

- **Life-time income**, which provides income only to the annuitant. It is often referred to as a Straight Life Income option. If the annuitant dies before all invested funds are collected, the insurer keeps any balances. There is no beneficiary designation because beneficiaries do not receive any leftover cash. This option is selected by those who want to maximize their monthly income, since it pays the highest amount among the payout options. This should not be surprising since beneficiaries will not receive anything and the insurer could come out ahead if the investor dies prematurely.

- **Life-time and Period Certain**, which guarantees income for a specific time period selected by the annuitant. There are several time periods offered, such as 5, 10 or 20 years, plus a life-time income if the annuitant lives beyond the time period that is guaranteed. If the annuitant dies within the guaranteed period certain, his or her beneficiaries will receive the balance of that guaranteed time period. Only the annuitant can receive a life-time income; beneficiaries would receive nothing beyond the specified time period. This payout option will provide
less income each month than the life-time option because there are beneficiaries listed that may receive income if the annuitant dies prematurely. These may also be called Guaranteed and then for Life annuities, but they are really a payout method rather than a type of annuity.

- **Period Certain**, (also called Term payouts) that pay for the time period selected but stops paying once that point or term is reached. For example, if a twenty year payout is selected, the annuity company will pay for twenty years only. Once that has been accomplished payments cease. These typically continue to pay beneficiaries according to the payout selected by the annuitant so if the annuitant selected a 10 year payout, died after receiving 7 years of income, the beneficiary would continue receiving the same income for the remaining three contract years. This option will pay more than the Life-time and Period Certain because the insurer knows it will not pay beyond the time period selected. These may be called Twenty Year Term annuities (or Ten Year Term, depending on the time period selected),

- **Lump Sum**, which is exactly what the name implies – the annuitant takes the entire amount in the annuity in a single lump sum payment.

- **Joint-and-Survivorship**, which covers the lives of two or more named individuals. These annuities are often used by married couples, but they can be utilized by any two or more individuals.

Agents and consumers will see payout options with a variety of names, but usually each type is more a description of the payout than a new type of annuity. Many of the other options have to do with additions added to the standard five payouts, such as an attached life insurance policy or inflation protection.

It is common to see annuity payout options listed as the annuity type. For example, a brochure may call an annuity a Guaranteed-and-then-for-Life annuity. This is actually the payout option described as the annuity. The annuity is a fixed annuity that will pay for a period certain and then for the lifetime of the annuitant if he or she lives beyond the time period selected. It could just as easily be called a Ten-Year Annuity or a Twenty-Year Annuity. It each case, however, it is actually a fixed rate annuity with a payout term of ten or twenty years.

How does the annuitant determine whether a life-time income (that pays less each month) or a specific term (that pays a higher amount each month) is the best selection? Since the retiree has no way to know how long he or she will live, it may be more a question of looking at the entire retirement income picture when making the decision. Many retirement specialists automatically favor a lifetime payout option since that ensures income up to the time of death and will also mean the highest amount of income each month. It is unlikely that monthly living costs will go down, so it is unlikely that less income will be needed in the final years of life. Obviously less income is what
would result once a term annuity payout met the end of its term and stopped providing income. A lifetime annuity guarantees retirement income until death. On the other hand, family members are seldom happy to find out that there will be no inheritance if the retiree dies prematurely. No one likes knowing the insurance company will keep any remaining funds. Many annuitants end up selecting a life-time with Period Certain payout option to get life-time income while still guaranteeing either the annuitant or the beneficiaries will receive their investment principal. This option will pay less than the straight life-time option.

**Company Financial Strength**

Annuities are usually long-term investments so it is very important that the company selected be financially strong. Of course, agents should always use only top rated companies, but this becomes especially important for long-term vehicles. Unlike bank accounts, the federal government does not guarantee annuities. Since the company is promising lifetime income, the consumer also wants to be sure the insurance company is operating as long as their lifetime.

**Annuity Extras**

**Principal Protection**

Some payout options guarantee the annuitant or their beneficiaries will receive at least all the principal back. In other words, if the annuitant dies before collecting every last dollar he or she paid into the annuity, their named beneficiaries will receive the balance. Also called premium protection, the annuitant will continue to receive periodic annuity payments until the cumulative annuity payments equal the net investment. This is often stated as a type of annuity, but it is actually a payout option. As such, it will not provide as much monthly income as a straight life payout option will because the annuity company is accepting a higher level of risk.

**Cost of Living Protection**

It is possible to choose an annuity with automatic cost-of-living adjustments. When an annuity is purchased it is often for the purpose of receiving a certain amount of monthly income. As we know, inflation can dramatically decrease the buying power of that income over time. An annuity with “cost of living adjustments” (COLA) protects the value of the annuity income stream by adjusting the payments along with inflation or the cost of living. Inflation protection or cost of living adjustments can be very important in maintaining accustomed lifestyle during retirement. Nothing is free however. This feature comes with a price tag, usually in the form of lower monthly income than a straight life annuity payout.
The Ups and Downs of Annuities

Annuities go in and out of favor, usually depending on how the stock market is currently performing. When stocks are performing well, financial planners may condemn annuities as too conservative, providing low returns. When the stock market is performing poorly, however, annuities suddenly gain popularity due to their guarantees of principal and some amount of guaranteed interest earning. Annuities have always offered specific benefits over other kinds of retirement products, especially for those not able or willing to risk losing a portion of their retirement savings.

**Principal Protection** is an important feature of fixed and equity indexed annuities. Agents should be stressing this very important retirement investment feature. Additionally, most annuities guarantee a minimal amount of interest earnings. In the past, the amount of interest paid was usually higher than minimum guarantees, but when stock market performance became very dismal, those minimum guarantees provided more earnings than many stocks were able to do. Depending on the payout option chosen, it is also possible to guarantee that the annuitant or their heirs will receive back at least as much money as was invested in the annuity.

**Tax Efficiency**

The purchase of an annuity with qualified retirement savings, such as funds from a 401(k) plan or an IRA, can save the investor money on his or her taxes when compared to taking a lump sum payment. Qualified funds can be rolled into a qualified annuity without any tax penalties. The annuitant only pays taxes on the income the annuity provides.

An annuity, like all investments, is not perfect, but it is a great way to protect one’s quality of life in retirement. Retirement assets can be used to purchase guaranteed income for a specified time period or for the life of the investor and his or her spouse. Annuities provide many payout choices for the investor allowing him or her the freedom to make their own income choices in retirement.

**Supplementing Other Retirement Income**

Most financial planners would probably urge employees to first max out their 401(k) plan, if such a plan is available. This is sound advice since employers often match in part or whole the funds contributed by the employee. At some point, if the employee is financially savvy, he or she may max out their 401(k) plan since, unlike an annuity, there are limitations. Once the 401(k) plan has been maxed out, an annuity becomes an excellent financial vehicle to contribute to. The earnings will be tax-deferred, meaning the interest earned does not affect current taxation. Earnings are not taxable until they are
withdrawn. At one time, investors could claim they were first withdrawing the principal, which had already been taxed. Now the IRS says interest earnings are always withdrawn first, so taxes would be due on the interest portion. This is often called the “last-in-first-out” rule.

Reasons to Buy an Annuity

There are many good reasons to buy an annuity including:

- The investment earnings are tax deferred as long as they remain in the annuity. Income taxes on the earnings are not paid until withdrawn or paid out by the insurer to the annuitant.
- An annuity is free from the claims of creditors in most states.
- If the annuitant dies, accumulated values will pass to the listed beneficiary without having to go through probate. If payout has already begun, whether or not the beneficiary receives anything will depend upon the payout option selected by the annuitant.
- The annuity can be a reliable source of retirement income, providing freedom to decide how that income will be received.
- There are no income tests or other criteria; anyone may invest in an annuity.
- There are no annual contribution limits like those imposed on IRAs and employer-sponsored plans. Individuals can contribute as much or as little as they like in any given year.
- The investor is not required to begin taking distributions from his or her annuity at age 70½ (the required minimum distribution age for IRAs and employer-sponsored plans). The investor can typically postpone payments until the income is needed – or never do so if income is never needed.

Reasons to Avoid Buying Annuities

No investment is right for every person. Annuities aren't right for everyone either. Some potential drawbacks include:

- Contributions to non-qualified annuities are made with after-tax dollars and are not tax deductible. The interest earnings are tax-deferred, meaning the interest earnings are not taxed until withdrawn from the annuity.
- Once the annuity is annuitized, payments are locked in. There's no flexibility to change the payment amount or make discretionary withdrawals over and above the payment amount.
- Annuities have insurer-imposed surrender fees besides the early withdrawal fee imposed by the IRS (10% if withdrawn prior to age 59½). Insurer fees usually start high and go down one percentage point each year. For example, in a 7 year...
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surrender annuity, the first year would impose a 7 percent early withdrawal penalty, dropping one point each year thereafter. After the seventh year, no withdrawal penalty would be imposed by the insurer.

• Some annuities may have out-of-pocket costs for such things as annual fees, investment management fees, or insurance expenses.

• Annuitants will be subject to a 10 percent federal penalty tax (in addition to any regular income tax) if money is withdrawn from the annuity prior to age 59½, unless the annuitant meets one of the exceptions to this rule.

• Investment gains are taxed at ordinary income tax rates, not at the lower capital gains rate. This is often one of the biggest disadvantages of an annuity.

Making the Right Annuity Choices

Often it is not whether an annuity is the right vehicle, but rather if the annuity product chosen meets the investor’s needs. Choosing the right type of annuity can be critical to meeting investment goals. Consumers seldom know which annuity type best suits their needs, so it is typically the agent that must provide enough information for the correct choice to be made. It is important that agents not pre-judge the client’s goals, thus failing to provide full information.

The first step is determining the client’s goals in order to fully understand which annuity is likely to be appropriate. Often the goal is retirement income. Determine exactly when the client expects to begin receiving annuity income. Is he or she near retirement or years away from that date?

If the client is nearing retirement age, it is possible that he or she has a lump sum to deposit but if the client is much younger, it is likely that periodic payments will be made into the annuity vehicle, called a deferred annuity. A deferred annuity takes many years to accumulate cash build-ups and does not begin paying an income stream for many years.

For those either coming to or already in retirement an immediate annuity may be their goal, but not everyone annuitizes their annuity so even this should not be automatically assumed. As we know, an immediate annuity immediately begins paying an income stream to the annuitant. How long that income stream lasts will depend upon the payout option chosen at the time of annuitization. Payout options include a life time income stream but it is important to realize that the amount received each month is directly related to the amount of cash in the annuity. Obviously if the client has only accumulated a few thousand dollars, the monthly income will be very little – certainly inadequate to support the individual in retirement.
That brings us to the second step: how the annuity funds should be invested. With a fixed annuity, the annuity issuer determines an interest rate to credit to the investment account. An immediate fixed annuity guarantees a particular rate, and the payment amount never varies. A deferred fixed annuity guarantees the rate for a certain number of years; the rate then fluctuates from year to year as market interest rates change. A variable annuity, whether immediate or deferred, gives the investor more control and the chance to earn a better rate of return (although with a greater potential for gain comes a greater potential for loss). The annuity investor selects their investments from the separate accounts (similar to mutual funds) that the annuity issuer offers. The payment amount will vary based on how the investments perform.

**Many Annuity Choices**

Unfortunately agents do not always have the freedom needed to shop around for the right annuity. In some companies, the products are chosen by the brokerage and the agents have only those products to represent. However, agents do have the freedom to work elsewhere if the products represent more advantages to the company than to the agent’s clients. Some annuity products provide hundreds of dollars more each year than others. Why? Rates of return and out-of-pocket costs for clients can vary widely between different annuities. Of course, the insurer chosen should be reputable and financially sound as well. Refer to one or more rating agencies to determine an insurance company’s financial strength, investment performance, and other factors. Most professionals recommend checking more than one rating agency since their reports are a mixture of information. Check to see how the rating agency makes their determination as well; do they do their own research or do they rely solely on the information volunteered by the insurer?

Not all annuities are the same, although the differences are sometimes vague. The financial planning community views some annuities (particularly fixed annuities) as being the ideal solution to a retiree's need for guaranteed income because they have a very good reputation. However, some annuity products are viewed as unnecessary and very expensive. Whether or not this is true is partially opinion and partially fact in many cases, but it is important to know all the annuity features – both good and bad - prior to selling them. At no time should an agent ever omit facts when presenting annuities or any other insurance product to the client.

When stocks are performing well, fixed annuities are accused of giving lower returns than available elsewhere and this is often true. What investors and even financial planners may fail to take into consideration is the safety annuities offer. Safe investments always pay lower returns than riskier investments. Recent lows in the stock market have emphasized this very well. In return for the retirement income certainty provided by fixed annuities or equity indexed annuities the investor gives up the opportunity to make bigger returns by investing their money in assets that fluctuate in value, as stocks do. Even the safer mutual funds have seen downturns recently, again emphasizing the safety
of fixed rate annuities. A fixed annuity is considered to be a safe and conservative investment but this means the investor will not see the possible gains (and losses) of a riskier investment – like the stock market.

Although it is not necessary to annuitize, annuities are designed to do just that in order to provide monthly income. A problem with annuitizing, however, is the inflexibility that results from annuitization. Annuities are typically less flexible than some other retirement options; once the annuity contract is annuitized the capital is tied up in the annuity, meaning the annuitant no longer has access to that lump of money. Perhaps that is why so many annuities are never annuitized. Perhaps the investor prefers taking out sums of money periodically rather than receiving a guaranteed income stream. Some retirement planners recommend their clients reserve at least 40 percent of their retirement assets for unforeseen circumstances. Annuitized annuities are not ideally suited to cover large unplanned expenses but if the contract is never annuitized it may be possible to use them for such things (depending on whether or not the annuity is still in the early years when there could be surrender fees involved).

Annuity products can be structured to strengthen an individual’s retirement financial plan. As we seem to be repeating in this course, the best type of annuity for retirement is a fixed lifetime annuity. Many planners would recommend an annual Cost of Living Adjustment that protects the income from the effects of inflation be included. A fixed lifetime annuity gives the investor an income stream for the rest of his or her life – no matter how long he or she lives and it offers a guaranteed payment regardless of stock market performance.

Annuity products are not perfect. Although they provide exactly what most retirees need - guaranteed income – annuities also tie up the capital, so the investor loses flexibility. However, trading flexibility for guaranteed income is not necessarily bad. One of the major retirement mistakes is over-spending in the early years of retirement, so the inflexibility may actually be an advantage, although some planners consider it a downside to using annuities. Since so many people do over-spend in the first twenty years of retirement (using up all their savings when they still have another ten years of living) perhaps it is a good thing that annuities do not allow the investor to dip into the lump sum of money held in the annuities; perhaps that is a selling point – not a disadvantage after all.

As every agent should know, not all annuities are created equal and many annuity products and features are actually a bad feature for retirees. In addition to choosing between a fixed (mostly recommended) or variable (riskier) annuity, there is also the matter of deciding where to purchase the annuity. Of course, agents would prefer to be the selling entity but they are available from many sources. Although the underwriting is always done by an insurer, annuity products can be purchased through banks, loan companies, and many other institutions.
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Annuities for Retirement

The most common problem in retirement is living longer than the money lasts. Of course, some of this is created by the retirees themselves. They make large purchases that should not be made (such as travel homes, for example) or over-spend in the early years. Many surveys show a major problem is underestimating at age 65 how long they are likely to live. Many new retirees plan for twenty years of living when they should be planning for 30 years in retirement.

Another error is failing to plan for the effects of inflation and rising costs of living. Today’s costs will probably not be tomorrow’s. Retirees must plan on needing progressively more money to cover the same routine bills. Gasoline goes up, electricity goes up, and property taxes go up. Seldom do any of our routine expenses go down over time. Retirement can be golden but if the retiree failed to adequately plan ahead with enough savings and investments the final years may mean poverty. Annuities are a great way to secure the future with continued income. Each person is responsible for his or her own retirement future. Financial mistakes can seldom be reversed once retirement begins.

Everyone is Living Longer These Days

We have always heard that women live longer than men, and that is still true – for now. However, both men and women are living longer. Those who reach age 60 have a very good chance of living into their eighties and nineties. In addition, the longevity gap between men and women is closing. Some 20 years ago, a woman aged 60 could expect to live for another 22 years, while a man of 60 could only expect to live for another 17 years. Now, a man who reaches age 60 can expect to live for another 21 years and a woman for another 25 years.

Although the gap is closing, currently the life industry expects women to live longer than men and so pays women a lower monthly pension amount. People who survive to 60 are living longer because of improved medical care, a greater willingness to go for check-ups and medical treatment, better screening for diseases, better education about diseases and how to treat them, and improved access to treatment. Many feel longer life is also a product of our increased willingness to stay physically active long into our retirement.

Coutts-Trotter and Peter Bond, the chief medical officer at Old Mutual Insurance, say the life expectancy of men has improved faster than women because:

- Men are smoking relatively less than women than in the past.
- Improved medical treatments for heart/circulatory and related illnesses have a bigger effect on men, who tend to die of these illnesses more than women do.
Women are suffering from increased stress. More and more women are working in the formal sector, as well as having to manage the home. The added stress brought about by women’s changing role in society has an impact on their mortality and morbidity. On the other hand, the role of men in society has remained pretty much unchanged.

There has been more room for improvement among men, who are now better educated about health, using preventative measures such as screening to detect problems at an early stage.3

Putting Off Retirement

When the retirement accounts of many Americans dropped by up to 45 percent in 2008 and 2009 due to drops in the stock market many people who had planned to retire were forced to rethink their retirement date. Individuals lucky enough to have a guaranteed pension through their employers were suddenly the lucky few. Most people fund their own pension plans, whether through 401(k) plans, Individual Retirement Accounts, or simply by putting away a few dollars whenever possible. Those who are self-employed (as most insurance agents are) must especially be diligent in planning for their eventual retirement. The question is always the same: will I outlive the wealth I have created?

Each person must personally be responsible for their own retirement. While any financial planner will gladly help a client figure out their future, none can guarantee that all will be fine. Ultimately it is always up to the worker to save adequately for retirement.

Annuities always look better to financial planners when stocks are down, but even when they have not been down, annuities continued to be used to some extent. Annuities got a famously bad rap in the 1990s because of their unfamiliar - and surprisingly steep - fees. Since then, the variety of annuity products have expanded and some of the fees are down, especially if the agent shops around for products to represent. In recent years, annuities have offered so much personalization that just about everyone can find one they like. That does not mean that the annuitant will have saved adequately. While everyone agrees that saving something is better than saving nothing, inadequate savings is not a solution. We know by now that Social Security is not adequate to live on, yet fewer people are putting away money for their retirement. As a result, many older people are deciding to retire later than they otherwise might have. Unfortunately job layoffs are affecting those who would have liked to continue working.

No matter how many bells and whistles are added to them, annuities still come in the two basic formats: fixed and variable. As we have said, fixed annuities yield a steady stream of income for a set number of years or the rest of the investor’s life. Variable annuities can also provide regular checks, but they tie the amount of payouts to the

3 1st quarter 2006 edition of Personal Finance magazine
performance of an investment portfolio. Both types allow the individual investor to choose whether to begin receiving payouts immediately (in monthly, quarterly, or annual installments) or at a later date; both varieties pay out partly taxable money - taxed only on gains, not the original investment - at regular income tax rates, an important fact to weigh when considering annuities for any financial plan.

Annuities are offering a wider variety of options, but they really are just that: options. Fixed annuities can be purchased with inflation protection added to the payouts; a death benefit can also be attached to the annuity. Some policies offer an option for long-term-care insurance, which raises the payouts if the investor becomes disabled. On certain variable annuities, the investor can opt to have their portfolio value (and therefore their payouts) reflect the performance only in neutral or good years.

All options typically come with a price tag. Clients should never be allowed to assume anything different. For fixed annuities, the price comparisons among different firms’ offerings are relatively simple: "It all comes down to how much money you put in and what initial payment that produces," says a T. Rowe Price senior financial advisor.

On variable annuities, the cost of a specific feature is usually expressed as percentage points deducted from your returns. Unfortunately, few clients would realize this so it is up to the agent to inform them. Only if the client actually wants a feature should it be included. Features that limit downside investment risk tend to cost anywhere from 1¼ to 1½ percentage points deducted from the annual portfolio returns. That is on top of annual investment-management fees, which vary among companies and even among products of the same company.

For fixed-annuity holders, financial planners often feel the most important extra to consider is inflation protection. Even modest price increases can damage purchasing power over time. For example, an individual retiring on $100,000 a year in 1980 would need $253,000 a year today to maintain the same lifestyle. Inflation protection in the form of annual adjustments to income from the annuity is costly. It will reduce about 30% from the first payout received. Even so, it may be worthwhile considering that the insurance company takes on a big unknown – namely, how long the investor will live.

Not everyone will be willing to reduce their initial fixed annuity payouts by 30 percent. Perhaps their level of savings was too low, for example, to permit such a reduction. If inflation protection seems too expensive, the investor could buy a policy with an escalation clause, stipulating a lower annual payout increase (in other words, less than the actual inflation rate). This still comes at a price however. It may reduce initial payouts by 25 percent - less than the 30 percent for actual inflation rates, but still pricey. Notes T. Rowe Price’s advisor: "I like this feature because it's more affordable, and it keeps you apace with inflation in all but the really bad years."
Most of us purchase fire, health and car insurance, yet we fail to protect the most serious risk faced in retirement: living longer than our assets. Our second retirement failing is underestimating the cost to live decently in retirement. Guaranteeing a monthly income is not the same as guaranteeing an adequate monthly income during retirement. Agents cannot do this for their clients; if the client has saved inadequately, all their agent can do is provide some income – not necessarily adequate retirement income.

An annuity could be compared to a pension plan since it will provide income to the end of one’s life. The difference is important however: the investor must fund this annuity pension because there is no employer doing it for them. That’s unfortunate since the employer would make sure the pension was funded each and every month. The private investor may not necessarily do so.

Fixed Rate Annuities

An annuity is a contract purchased with a sum of money to provide the buyer or annuitant with regular payments in return. Annuities work like loans in that an individual purchases an annuity from a company and gives the company a large sum of money. In return, the company pays back the sum of money over a period of time plus interest. Typically taxes are deferred on annuities until the payments are made to the annuitant.

How Fixed Period Annuities Work

Annuities can vary in amounts paid, frequency of payments, and time periods over which the payments are made. Under some circumstances an individual annuitant can decide either how much is paid in each payment or the period of time over which payments are made. Since the total sum of money received each month is decided upon by the amount held in the annuity at the time of annuitization, a shorter fixed period annuity would typically have larger payments to the annuitant than a longer fixed period annuity. In some cases, a life time annuity payout would be very little each month if the amount saved in the annuity was inadequate.

If the annuitant wants a specific amount of income each month that amount would determine how long monthly payments could be made. Obviously, it requires sufficient funding to provide specific amounts of income each month for a long time period. There are typically multiple payout options available for each annuity. That would not necessarily mean all payout options would produce the results desired by the annuitant since it all comes down to how much he or she saved.

Fixed period annuities are annuities where the individual annuitant or owner/purchaser of the annuity chooses the amount of time over which the annuity is paid back. Fixed annuities pay a fixed amount over a fixed period of time chosen by the annuitant. The amount of time is usually a function of many years (such as ten or fifteen years) during
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which annual, bi-annual, or monthly payments are made to the annuitant. Fixed period annuities usually offer the following payout categories:

- **5-year fixed period annuity**, level payments are made over a period of five years;
- **10-year fixed period**, level payments are made over a period of ten years;
- **15-year fixed period annuity**, level payments are made over a period of fifteen years;
- **20-year fixed period annuity**, level payments are made over a period of twenty years;
- **Lifetime fixed annuity**, paying the annuitant for his lifetime regardless of how long he or she lives. Beneficiaries would not receive any remaining funds even if the annuitant died before all invested funds had been returned by the insurer. Therefore, this payout option gives the maximum monthly income available.
- **Joint-and-Survivorship Lifetime fixed annuity**, guaranteeing income for the lives of two or more individuals. This payout option is often used by spouses, but any two or more people can utilize them.
- **Period Certain, plus Lifetime fixed annuity**, guaranteeing a specific length of time over which payments will be made, either to the annuitant or their beneficiary, with lifetime income guaranteed to the annuitant. The beneficiary would only receive the remainder of the guaranteed period of time if the annuitant died prior to receiving income during the “period certain.”

Many industry experts feel too little time and thought is given when selecting payout options. Annuitants often assume that beneficiaries will always receive remaining investment funds, even when that is not the case. It is a foolish agent that does not fully communicate the situations under which beneficiaries receive nothing. Many industry experts recommend using a disclaimer when the annuitant chooses to take the maximum payment, leaving nothing to their heirs. Having the annuitant sign such a disclaimer stating that he or she fully realized their beneficiaries would receive nothing prevents discontent or even legal action following the annuitant’s death.

**Variable Annuities**

A variable annuity is basically a tax-deferred investment vehicle that comes with an insurance contract designed to protect the investor from a loss in capital. Thanks to the insurance involvement, earnings inside the annuity grow tax-deferred and the account is not subject to annual contribution limits. In a variable annuity the investor chooses from among a range of different investment options, typically mutual funds. The rate of return
on the purchase payments, and the amount of the periodic payments eventually received will vary depending on the performance of the investment options the annuitant selected.

Generally the investor chooses from a menu of mutual funds, known as "subaccounts." Withdrawals made after age 59½ are taxed as income. Like most annuities, earlier withdrawals are subject to tax and a 10% IRS penalty.

Variable annuities can be either immediate or deferred. With a deferred annuity the account grows until the investor chooses to begin withdrawals, which should be after age 59½ to avoid penalties. The annuity may be annuitized, using one of the payout options, or the investor can withdraw money as he or she wishes (never annuitizing the contract).

Like most annuities, variable annuities are long term investments. The longer the annuitant allows their money to build, the more he or she is likely to gain from the investment. However, unlike a fixed annuity (where the funds sit in an account from which payments provide a fixed income throughout a fixed time period), a variable annuity gives the investor more control over their investment but also gives the investor the burden of risk. There should be no mistake on this point – variable annuities do include investment risk.

The money deposited into variable annuities can go into the investor’s own account, separate from the investment portfolio of their broker or insurance company. The investment choices are, therefore, the investor’s to make.

As one nears retirement, it often wise to avoid riskier investments since the time to make up losses is not there. Younger investors are more likely to favor variable products since they do have time on their side and they may actually enjoy involving themselves in the investment choices. These investors may want to play the money market, or invest in stocks, bonds, or equity funds. The variable annuity returns depend on the account's performance rather than just rising and falling with the fortunes of the firm that holds it.

Variable annuities often provide a wider spectrum of investment opportunities for retirement savings, while providing professionally managed fund options as well.

**Annual Expenses**

The investor’s broker or insurance company may guarantee the principal investment, minus withdrawals for any of the following annual expenses.

- **Annual annuity charge.** This fee is based on the total value of the variable annuity, plus the cost for the broker or insurer administering it and giving the investor the option of a lifetime's worth of annuity income. When the contract with the annuity broker provides for death benefits, annual annuity charges
increase. This is generally computed by adding M&E (mortality and expense risk) to administration charges.

- **Maintenance fee.** This is simply a yearly fee for maintaining the contract. It pays for contract administration and communication services.

- **Underlying fund fees.** The broker holding the variable annuity will normally charge an annual fee for managing the investments.

- **Surrender charges.** If the investor withdraws their money within the first three to ten years of the day he or she took out their variable annuity, he or she has to pay surrender charges based on a scale of declining charges from 7% to 0%.

Agents should never assume that the percentages or costs we have listed apply to all annuity products. Companies continue to change, add, or delete features as they try to gain additional clients, market shares, or correct faults within the products.

**Funding Variable Annuities**

Investors should first maximize their retirement options as far as their individual retirement accounts (IRA) or employer-sponsored programs are concerned. If the investor still has some money they still wish to invest towards their retirement, then a variable annuity could be a good option. Since this is a risk vehicle, few professionals would recommend it as the only retirement investment.

It is possible to either purchase a variable annuity outright or make regular deposits to it over time. The investor usually has the option of trading any current annuity for a variable annuity. However, transferring funds from an already tax-deferred plan, such as a 401(k) plan, into a variable annuity will not add value to the investment since the investor would just be paying their broker fees for tax deferral they already have.

Popularity is no indicator of practicality. Not everyone needs an annuity and certainly not everyone should buy a variable annuity due to the risk involved. Many professionals favor buying plain old mutual funds over annuities, although mutual funds lend themselves to spending mistakes in retirement that may be avoided with an annuitized annuity.

**Variable Annuity Fees**

Variable annuities do have fees. Some financial planners feel the amount of fees are extravagant in some variable annuity products, so the wise agent will certainly shop around for the products they want to represent.
Dollars and Sense

Chapter 6: Annuities

Variable Annuity Death Benefit

The variable annuity death benefit basically guarantees the account will hold a certain value should the annuitant die prior to annuity payments beginning. With basic accounts, this typically means the beneficiary will at least receive the total amount invested even if the account has lost money. For an added fee this figure can be periodically increased. If the investor decides not to annuitize the death benefit typically expires at a specified age, often around 75 years old.

Surrender Fees

Most annuities have surrender fees that are due if the investor does not keep the annuity for several years. The actual length of surrender fees varies, but they are usually between five and ten years, with seven years being common. Withdrawing funds during this time will result in fines, although many annuities allow the interest earnings to be withdrawn penalty free. Surrender fees typically decrease as the years go by, often by a percentage point each year. For example, in a five year surrender period, the first year may impose a 6 percent penalty, 5 percent the second year, 4 percent the third year, 3 the fourth year, and 2 percent in the fifth and final year. Always consult the contract for exact penalties.

Early Withdrawal Penalty

As with most retirement accounts, if the investor withdraws funds prior to age 59½, he or she will be charged a 10% early withdrawal tax penalty.

Taxation

Gains in variable annuities are taxed at ordinary income tax rates, which can be high. In fact it can be substantially higher than their taxes on long-term mutual fund gains. The difference can eat up the advantage of an annuity's tax-free compounding. It may take from 15 to 20 years before tax-deferred annuities become more tax efficient than a mutual fund, even though the mutual fund is not tax-deferred. However, many people do keep annuities for 15 to 20 years or even longer. Additionally, many people are not looking at how the gains will be taxed because funds will be gradually withdrawn as lifetime income or because they will be in a lower tax bracket in retirement.

Equity-Indexed Annuities

An equity-indexed annuity is a special type of annuity. During the accumulation period the insurance company credits the investor with a return that is based on changes in an equity index, such as the S&P 500 Composite Stock Price Index. The insurance company typically guarantees a minimum return. Guaranteed minimum return rates vary. After the accumulation period, the insurance company will make periodic payments to the
annuitant under the terms of the annuity contract, unless the annuitant decides to receive their contract value in a lump sum.

Variable annuities are securities regulated by the SEC. Fixed annuities are not securities and are not regulated by the SEC. Equity-indexed annuities combine features of traditional insurance products (guaranteed minimum returns) and traditional securities (returns linked to equity markets). Depending on the mix of features, an equity-indexed annuity may or may not be a security. The typical equity-indexed annuity is not registered with the SEC.
Employer Sponsored Pension Plans

There was a time when employee benefits plans were growing at a rapid rate. They were considered a vital part of labor contract negotiations. Today that is less likely to be true as companies try to cut costs, staying competitive, and survive in an economically uncertain world.

Traditionally there were three primary reasons for using employee benefits plans:

1. To improve industrial relations,
2. To meet union demands, and
3. To allow key employees the ability to provide for their own insurance and retirement needs at a reasonable cost.

Many feel employee benefit plans enable employers to attract better and more qualified employees, reduce costly employee turnover and improve employee morale and, therefore, also improve employee efficiency.

Since 1948, when the National Labor Relations Board ruled that insurance and pensions were subject to collective bargaining, these benefits were important union demands. It was due to union demands that so many employers felt forced to initiate pension and medical plans. Today many people take jobs not for the satisfaction the job will provide but rather for the medical coverage provided. If there is a pension paid for as well, that is just a bonus.

Today’s employers may offer pensions but they are increasingly funded by the employees with the employer acting more as a manager than a pension contributor. Many employee funded pension plans do, however, receive matching funds in part or whole from the employer.

Private Pension Plans

There was a time when Americans expected their employers to fund their pension plans. As the cost became increasingly expensive, however, employers began moving from an
employer-sponsored pension to an employee-sponsored format, meaning that the employees became increasingly responsible for creating their own pension funds (although there were employer incentives, such as matching or partially matching employer funds).

In 1974, **ERISA (Employee Retirement Income Security Act)** set standards for private pension funds that included funding, participation, vesting, termination, insurance, disclosure, fiduciary responsibility, and tax treatment. Prior to ERISA, assets to fund private pensions were the largest private fund accumulation not subject to strict federal regulations.

To provide employees with maximum security, private pension plans require realistic actuarial estimates of future benefit costs and provisions for accumulating funds for the benefits as they are due. **Funded pension plans** are those for which an excess amount of that needed to pay current benefits to retired employees is accumulated by the employer with a trustee or an insurer. The trustee is usually a bank, though not necessarily. Other institutions may also be used. The funding method used will determine how much is accumulated in excess of the current disbursements. A sound funding method is very important to adequately protect the employee pension expectations (to make sure the employee receives in retirement approximately what he or she expected to receive). The funding provisions of ERISA require full funding of current service costs and amortization over minimum periods for funding accrued under past service liabilities.

Group retirement plans are more complex than are group life and health plans. There are tax considerations, questions of finance and employee relations involved, as well as other possibilities. ERISA, IRC, and the IRS rulings set forth broad requirements for a qualified pension plan. Basic decisions relating to pension plans must be made as to employee qualifications, conditions under which benefits are payable, benefit levels and types of benefits available. Cost, competitive conditions in the labor market, and the desire for an effective personnel and employee relations policy are important considerations in designing retirement benefit plans.

For a benefit plan to be qualified, certain requirements must be met:

1. It must be established by the employer;
2. It must be for the exclusive benefit of the employees and their beneficiaries;
3. It must be in existence and in effect;
4. It must be in writing;
5. It must be permanent;
6. It must be communicated to the employees;
7. It must be financed by contributions made by either the employer, the employee, or both;

8. It must be nondiscriminatory with respect to coverage and/or benefits;

9. It must be based on a defined contribution or benefit formula;

10. There must be no possibility of permitting a reversion of contributions to the employer prior to the satisfaction of all liabilities to the employees or any other fund diversion for the benefit of other than employees.

Under the IRC (Internal Revenue Code) provisions, a qualified plan must be for the benefit of employees in general. They cannot be for specific persons alone. Therefore, the plan must meet one of the following criteria tests:

1. At least 70 percent of all employees must be covered.

2. If only specific classes of employees are covered, such classifications must not discriminate in favor of officers, stockholders, supervisors, or high-salaried employees.

Plans meeting the percentage test automatically satisfy the coverage requirements of the IRS (Internal Revenue Service). For the classification test, nearly any classification is acceptable if it does not violate the nondiscriminatory requirement. One classification not permitted is that of union employees only or nonunion employees only. That would clearly discriminate against one group or the other.

ERISA requires that employees who are 25 years old with one year of service be covered. However, three years of service can be required if employer contributions are immediately 100 percent vested.

Among the common eligibility standards in pension plans is that employees be actively employed on a full-time basis. ERISA has eliminated many of the former restrictive participation requirements. ERISA has also improved the status of part-time and seasonal employees, as well as re-employed participants. Some plans require no probation period for eligibility. This is especially true for collectively bargained plans.

Pension plans may specify a “normal” retirement age, at which an employee is eligible for full benefits. A compulsory retirement age may also be stipulated. If one were to follow the example of social security, for instance, age 65 would be the so-called “normal” retirement age, with 68 perhaps being the compulsory retirement age. Workers would, if these happened to be the designated ages, be encouraged to retire at the age of 65, and required to retire no later than the age of 68.

There are some industries where age 65 is considered inappropriate for the occupation, so the retirement age is lower. If an earlier age (earlier than 65) for retirement is required
by the occupation, then there is no loss in benefits, because the designated age is
considered to be the “normal” retirement age. However, if the worker wishes to retire
prior to the stated normal retirement age, then usually that worker would have to take a
reduced retirement benefit amount by retiring earlier than what is considered to be the
normal retirement age for his or her particular occupation. Where delayed retirement is
permitted, employees may be entitled to an increased pension, but usually no additional
pension credits accumulate beyond what is considered to be the normal age of retirement.

Pension benefits usually are of the conventional type providing fixed dollar payments as
scheduled, but there can be other types, as well. Some plans take advantage of the
variable annuity principle, under which each periodic payment is a function of the
investment performance of the pension fund.

Under the flat amount formula all participants are given the same benefit regardless of
their earnings, age, or years of service with the company. This type of pension plan is
often used in negotiated plans, such as union contracts.

The flat percentage formula relates benefits to earnings, but not to the years of service
with the company. Under the flat percentage formula, a pension equal to a percentage of
an employee's average annual wage is paid to all employees completing a minimum
number of years of credited service to the employer. This formula gives no added benefit
for time worked beyond the number of years required. Those employees who fail to meet
the minimum requirement for time employed are given a proportionately reduced pension
amount. The actual percentage will vary from plan to plan.

The flat amount unit benefit formula relates pension benefits to years of service
(number of years worked for the employer or industry), but not to the actual earnings.
Generally, the employee is given one unit of benefit per month for each year of credited
service. The flat amount unit benefit formula is often used in negotiated plans.

Under the percentage unit benefit plan, the employee is given a percentage of earnings
for each year of service.

What happens when a pension plan is brought into a company where employees have
already accumulated several years of work history with the company? This will, of
course, vary but generally those employees are given credit for their previous years with
the company, but typically at a reduced rate. Those years with the company from that
point on will naturally be given full credit with the pension plan. This differential is
justified. The cost is greater because interest plays a significant role in pension financing.
There were no pension dollars earning interest prior to the pension plan's birth. Also,
benefits earned prior to the plan's inception will be fully funded by the employer, since
there was no employee contribution on previous year's service. Due to these reasons,
some plans will not recognize prior service to the company at all.
One very important aspect of ERISA is the plan termination insurance (called PTI). PTI guarantees the pension up to a specified amount despite inadequate funding. The Pension Benefit Guaranty Corporation (called PBGC), operating within the U.S. Labor Department, administers PTI, collects the premiums from employers, and guarantees payment of covered non-forfeitable benefits. All benefits under a plan, or plan amendment, in effect for five years at termination are covered. If the plan has fewer than five years of operation, the benefits are covered on a percentage basis.

ERISA requires that a plan designate a fiduciary to administer its operation. A person exercising discretionary authority or management control over the plan and/or the plan's assets, are fiduciaries, regardless of their formal titles. Fiduciaries are responsible for compliance with the laws and must use the "care, skill, prudence and diligence of a prudent person acting in a like capacity for the purpose of providing benefits to participants and beneficiaries and defraying reasonable plan administrative expenses."

The U.S. Department of Labor has charge of interpreting regulations and fiduciaries are held personally liable in the event that these regulations are violated. It is wise for a fiduciary to carry fiduciary liability insurance, as a result.

Plan administrators must file annual reports with the Department of Labor and also with the plans participants if the plan is terminated. There must also be an annual report filed with the Internal Revenue Service (IRS). Also the plan administrators must furnish participants with a plan description so that they are aware of the benefits when the participants first join the pension plan, and then at least every five years thereafter. Plan amendments, annual financial reports, any plans for termination, a statement of active participants' rights and inspections of the complete annual report must also be available upon request by participants.

Changing Plan Designs

Companies often find themselves in a situation of rising costs under an existing plan. What insurance agent has not had the experience of having a client request something less expensive? Therefore, the business may feel it necessary to initiate changes in their current health plan. This will normally begin with a company committee who will be responsible for making decisions regarding changes. It is almost certain to be a time-consuming process.

Normally, an analysis of the previous three years will be the first step necessary. The three-year report should contain a breakdown of the costs relating to claims that have been paid, as well as a basic report of the needs and desires of the employees. It should contain such things as statistical data on the types of services most frequently used by the employees (such as chiropractors, radiology, or whatever seems to be routinely used), the medical claims paid, the percentage of increase in claim amounts over previous years,
how this percentage matches trend, non-institutional services (outpatient services), institutional services (hospitals, etc.), and totals for all types of costs by year.

After studying the available data, it may be deemed necessary to cut back benefits. Obviously, employees do not like to see their benefits (of any type) reduced. Therefore, it is very necessary that the employees understand what the problems are and where they originated. The employees must be made aware of the changes that must be made as a result. Often employees will be supportive if the proposed cost shifting prevents an increase in their premium payments. If the employees are able to understand the complexity of medical benefit costs and how abuse of the system often leads to the loss of certain benefits, future problems may be avoided. It needs to be understood that the dollars going into medical benefits cannot be used for pay wage increases and/or other benefits.

During the redesign process, it is normal for outside consultants and insurance agents to be sought out. Generally, the opinions of several different agents will be weighed by the committee, so it is the agent who can best present his or her ideas that may well end up with the business. As is so often the case, verbal skills can be very important in several areas such as explaining the insurance plan well enough to be a part of the final decision.

The data will need to be weighed and alternative suggestions brought out to the committee for review.

Most committees end up suggesting stronger case management on the part of whichever carrier is selected, whether that is their current carrier or a new one. Many insurance companies do not want to be involved in reviewing the necessity of claims and, as a result, possibly being put in the position of having to deny claims. It is often felt that this will generate ill will between the carrier and the policyholder (which might result in lost business). However, this attitude is changing as employers begin to want this type of cost management.

Often, businesses re-bid their programs every three to four years as a routine procedure. This is to insure that they are getting a good value for their premium dollar. While getting bids can assist an employer in finding out whether the company is, indeed, getting a good value, the process can also be expensive. Often, consultants do advise employers to re-bid their current health plans. It should be understood that these consultants might be in a position to gain financially from the process. Therefore, the employer also needs to use his or her own good judgment. If the employer does feel that re-bidding is advisable, then funds must be set aside for the costs that will be incurred. A company with around 3200 employees should plan on spending between $4,000 and $7,000 to cover the costs associated with preparing the request for proposals and analysis of bids, if an outside constant is used. The larger the company and/or the more complex the plan and its options, the higher the cost will be to re-bid the plan. Smaller companies that
cannot get experience-rated plans will not have to budget any funds, because the cost is figured into the commissions that the independent agents earn.

There are alternatives to re-bidding health care plans. For example, comparable organizations and plans within the same area could simply be reviewed by a consultant. That would be far less expensive than actually re-bidding the current plan.

How would a company know whether or not they should seek re-bidding? There are no absolute answers, but there are some guidelines that can be followed. You may wish to re-bid when:

1. An extremely high loss ratio is being experienced on claims (90 percent or more of the total premium paid on an annualized basis).
2. The premiums are rising more than the national trend. For the trend definition, refer to the definitions at the end of this text.
3. A move from a fully self-insured plan with internal administration to a self-insured plan with a Third Party Administrator (TPA) is being considered.
4. A move is being considered from a fully insured plan to a partially self-insured plan.
5. State and/or federal regulations have mandated plan design changes, which are not included in the current health plan.
6. Employees and management personnel are unhappy with the present carrier, for whatever valid reason.

If any of these conditions exist, it is possible that a change needs to be made. However, major changes need to be made using much thought and common sense. Generally, it is recommended that either the plan design or the carrier be changed, but usually not both items at the same time.

If it looks like both the plan design and the carrier are in need of change at the same time, it must be realized that the employees may be adversely affected (either in actuality or in the way the plan is perceived by the employees). Therefore, great care must be taken to educate the employees as to what changes are taking place and why. Even so, during the first six months, a company may expect to spend a great deal of time with their employees to clarify misconceptions and to put concerns at rest.

Before changing a current carrier, a business should first provide a list of the plan design changes being considered to its current carrier. If the current carrier is able to handle the changes, at a cost that is competitive, it is often easiest to continue working with the same carrier. Because plan design changes are based on utilization review data, and are aimed at correcting existing problems of either misuse or perhaps overuse, the current carrier
should be willing to work with the employer (the business). If, however, the current carrier seems reluctant, unwilling, or unable to work with the employer, then there is probably no point in wasting time with that carrier. The employer may as well just put the medical plan up for bidding.

When designing group medical coverage, there are several factors that must be considered. First the goals of the plan must be established. As with anything, it is impossible to have effective planning if no clear goal is established.

Also, decisions must be made regarding such things as deductibles and co-payments that employees must make. Other provisions, such as stop-loss amounts and additional benefits, must also be discussed and set down on paper. All of this allows potential providers of medical benefits to have a clear idea of what they are bidding on.

Sometimes a flexible spending account (called FSA) is established that allows individual staff members to pay pretax dollars for otherwise uncovered medical, dental, vision, or childcare benefits. FSA may also be used for additional medical or life insurance premiums.

Some carriers do use cost-management practices and these companies generally do a better job as far as premium costs are concerned. The types of procedures used will vary from company to company. They may include, but are not limited to:

1. Audits of hospital and doctor bills;
2. Concurrent review and discharge planning;
3. Home health care benefits to reduce the length of hospital stays;
4. Hospice benefits to reduce the length of hospital stays for the terminally ill;
5. Hospital length-of-stay assignments (similar to Medicare's system);
6. Incentives for outpatient surgery rather than inpatient surgery;
7. Incentives for outpatient diagnostic and pre-admission tests;
8. Individual case management;
9. Weekend admission limitations. This limits such things as being admitted on a Sunday afternoon for a Monday surgery, which is often unnecessary, since a Monday morning admission would work just as well.
10. Long-term custodial care;
11. Pre-certification and pre-admission review programs;
12. Required second opinions prior to surgery. Many feel this is more than simply cost-containment; it is good sense as well.

13. Wellness benefits.

These thirteen items have sub-categories which may include such things as well-baby care for prevention of future medical problems (costs), preferred pharmacy options with participating pharmacies and on-site case management of all hospital admissions. As medical costs soar, cost management procedures will become increasingly important to employers who want to keep premium costs under control. Sometimes, however, a side effect turns up. That side effect is the cost incurred in managing the medical program. A company can spend as much on the management as was saved on the medical costs.

**Flexible Spending Accounts**

Flexible spending accounts, called FSA, have often been used, since the accounts offer tax savings for both employees and employers. FSAs are accounts that employees make deposits into. Their deposits pay for such benefits as childcare, extended medical coverage, life insurance, and other special benefits. These plans must have administrators who handle the funds.

As of 01/01/90, employers must carry some of the risks associated with Flexible Spending Accounts. Health care expenses under FSAs' must be treated like life insurance. In other words, if the employee has only accrued $500 in their account and then has claims amounting to $2,500, the complete $2,500 must be reimbursed, even though that employee does not have that much money in their FSA account. As a result of this requirement, many employers stopped offering FSAs.

Some of the FSAs use the employee's pretax dollar contributions, while others are funded by the employer to some degree. If the employer funds the account, it is usually in the form of a "credit" for having taken a less expensive medical plan, which the company would have paid for. In some instances, it may also be due to taking either a reduced life insurance benefit or eliminating the life insurance benefit altogether. The savings to the employer is then "credited" to the Flexible Spending Account for the employee to use as he or she chooses, as long as it is within the IRS guidelines for such accounts.

As of 1984, the IRS stipulated that such money can be spent in only three areas:

1. For medical expenses that are not covered by the company's medical plan. This might include such things as plan deductibles or dental care.
2. For the care of a dependent person, whether that be a spouse, child, parent, or sibling.
3. For a group legal plan.

In a way, there was previously a fourth option. If the money was not spent on any of the three listed items, the employee could withdraw the money (take the cash). That is no longer allowable.

It is easy to see why flexible spending accounts caught on so well. As we stated, however, employers are becoming more reluctant to use them. Employers now have a financial stake in these accounts that they did not previously have.

There was one other point that was too good to last. In the beginning, the employees did not have to decide in advance what benefits they wanted funded by the FSA. Now, the Internal Revenue Service has mandated that employees must decide at the beginning of each year exactly where their account is to be spent. If the employee guesses wrong regarding which benefits he or she will need, it does not matter. The theme has now become one of "use it or lose it." That is because it is no longer possible, as we stated, to cash out the plan at the end of the year. In fact, any unused cash cannot even be left in the account for use in the following year. Between this change and the possibility of financial cost to the employer (for medical benefits), there is certainly the chance that the flexible spending accounts may be used much less as an employee benefit.

**Benefit Plans for Retirement**

**Defined Benefit Plans**

Today’s employees feel very lucky if they have an employer-sponsored retirement plan. One type of employer-sponsored plan is called a **defined benefit plan**. Although it is much less likely to be offered by today’s businesses, they were the cornerstone of the retiree income system in the past. These plans began in the forties and fifties, but on a very small level. However, they rapidly expanded and evolved into some of the most efficient pensions employees had the pleasure of participating in. They were “defined” benefit plans because the monthly income employees received in retirement were “defined;” the employee knew exactly what he or she would receive each month. Many also had cost-of-living raises built into them.

Life insurance companies were often used to design and manage the programs. These programs included such incentives as salary continuation after retirement, medical benefits after retirement, and deferred compensation. As time went by, many companies began creating and administering the programs themselves as a way of containing costs.

Retirement benefit plans for the general workers became increasingly expensive. Critics have argued that the defined benefit plans:
1. Became too costly to administer.

2. Had unpredictable funding.

3. Did not provide adequately for workers who were constantly changing jobs.

4. Did not allow employees to manage their own retirement funds.

Whatever problems existed in defined benefit plans, their strength was their flexibility of design and the security they provided for workers who often did no personal planning for themselves. These retirement plans benefited thousands of retired people who would otherwise have experienced poverty in their last years.

The strength of the plans may not have been fully recognized by those that received them. There was the assumption that companies would continue to offer defined benefit plans, making personal retirement savings unnecessary. At specified ages, a specific benefit was available. For example, a worker could elect to retire at the age of 62 rather than the normal retirement age of 65. In many plans, there was no reduced benefit due to early retirement if other criteria were met. Some plans simply stated that benefits would not be reduced after 30 years of service, regardless of retirement age. Some employers wishing to reduce the work-force offered full retirement benefits at an earlier age.

**Defined Contribution Plans**

As defined benefit plans became increasingly expensive, many companies changed to defined contribution plans. Defined contribution plans allow employees to manage their own money and forces employee participation. Few people plan effectively for their own retirement; it just seems easier to let the employer plan and implement it for them. The emergence of defined contribution plans required workers to plan for themselves.

Defined contribution plans were initially used by executive benefit programs to attract and keep the professionals needed by any given company. Many corporations now use life insurance contracts in some form to fund their executive benefit programs because of the safe and dependable rate of return. In addition, any death proceeds the corporation may receive as the listed beneficiary are free from federal income tax. In the fifties and sixties, corporate clients were basically sold in the same way individual clients were. Consequently, these types of sales were slow to catch on.

**401(k) Plans**

The 401(k) Plan has become a major source of retirement income. These plans became a popular vehicle purely by accident; no particular entity or political force championed them, not even employees themselves. Section 401(k) of the Internal Revenue Code was added to resolve a conflict between Congress and the Treasury Department over tax-
deferred profit-sharing plans adopted by many banks to replace cash bonus plans. It was this fluke that created one of the most widely used and appreciated retirement savings plan: the 401(k).

At the time, higher-paid employees deferred as much of their earnings as possible to their retirement plans to avoid the up to 50% tax levied on their earnings. Lower-paid employees generally took any elective amount as cash to supplement their lower incomes.

As employees became aware of the possibilities of the 401(k) plans their popularity grew, especially among higher paid employees and those who took their retirement seriously. Government eventually sought to restrict the growth of the plans, even though contributions were elective, since the effect was a tax advantage for higher-paid employees. Eventually Congress included a provision in ERISA that froze their tax status through 1976. When Congress passed the Revenue Act of 1978, Section 401(k) remained virtually unnoticed and passed into the Internal Revenue Code. It provided a new avenue for saving on a tax-deferred basis, certainly an advantage for those saving for a number of years as is typically the case for retirement.

Section 401(k) actually added just one paragraph to the Internal Revenue Code (probably why it received so little notice from lawmakers) requiring cash-deferred vehicles to meet a special non-discrimination test. Employee benefit specialists knew Section 401(k) made it possible for them to establish new cash-deferred profit sharing plans for their employees, especially higher paid employees who previously received company bonuses.

The non-discrimination test meant that lower paid employees must use 401(k) plans as well as higher-paid employees. That meant companies needed to find a way to encourage lower paid employees to participate. Therefore, employers offered a matching or partially matching contribution for every dollar the employee saved (for example, if Emily Employee contributed $10, her company might contribute $5 to her retirement account or half of her contribution). Generally, companies designated a maximum per year per employee they would contribute to prevent having to commit more money than they wished to. For example, if Emily Employee works for a company that matches her contributions dollar-for-dollar it is likely that her employer will specify an upper maximum, such as $5,000 (the employer will contribute no more than this maximum amount per year). The dollar amount contributed by the employer translated into “free” money in the employee’s retirement fund, as long as employee’s met their own contribution plan requirements. Generally employee contributions were made through automatic salary reductions so that employees did not see, so did not miss, the contributed dollars.

Ironically, the inventors of the 401(k) plans (R. Theodore Benna and his company) initially offered the idea to two of the largest insurers at that time; both turned him down.
Eventually, they marketed the idea themselves, using their own company. On January 1, 1981 Johnson Companies converted their after-tax savings plan to the first 401(k) savings plan in the United States. Eventually the Treasury Department issued regulations supporting the 401(k) concept, but initially most companies were skeptical that use of such plans were legal and were concerned that they might attract unwanted IRS attention.

Many politicians wanted to eliminate 401(k) plans entirely due to massive loss of tax revenues. The government eventually modified the Tax Reform Act of 1986 (TRA), reducing the maximum amount employees could contribute each year from $30,000 to $7,000 and imposing more restrictive and complex non-discrimination tests.

No plan is perfect and it is possible to make investing mistakes using 401(k) Plans as well as any other type of financial vehicle. However, anyone who is saving money versus spending it is doing something right. Certainly no worker would object to their company contributing retirement funds on their behalf.

Many 401(k) plans allow plan participants to invest in risky vehicles so investors should not automatically assume that all available options are safe ones. Each investor has what is referred to as “risk tolerance.” While professionals generally believe younger investors can absorb loss (so investing in riskier investments may be advised) if the investor is not risk tolerant even younger investors may then need to avoid some types of investments that would cause them mental anguish.

Older investors must look at how much time they have to make up potential losses. It would be foolish, for example, for someone nearing retirement to invest in volatile securities, and then sell in a panic if values fell dramatically. A novice investor will not have the same knowledge as a seasoned investor; an older investor will not have the same risk tolerance as a younger worker, and so forth. Each investor must choose according to his or her own personal circumstances and risk tolerance.

Perhaps the biggest mistake people make is failing to take full advantage of their employer’s 401(k) plan, especially when the employer matches funds to some degree. Not utilizing the availability of a 401(k) plan is the same as passing by free money. How is it free money? In two ways: first the 401(k) funds grow tax-deferred, allowing interest to earn additional interest; secondly, if the employer even partially matches the employee contributions it is money the investor would not have otherwise had. Typically, the only criterion is that employees must deposit a portion of their own earnings (often stated as a percentage, such as 3 to 5% of gross earnings). According to Keys to Investing in Your 401(k) Plan by Warren Boroson, about 30 percent of those who are eligible to participate in 401(k) plans fail to do so.

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Wealthier individuals are more likely to participate in 401(k) plans and this is not surprising. Lower paid employees often have trouble making it from check to check and they are less likely to save for retirement as a result (although they still should). In fact, many economists have noted that it is the lower-earning employees that would benefit the most from participating in their company’s 401(k) plans since the matching employer funds often amount to an immediate 50 percent return on their savings. Since lower-paid employees are less likely to be able to save sufficiently for retirement, such returns are especially needed to provide security later on in life.

By now it is well known that Americans save too little for their retirement; we are a nation of spenders. The frugal era of our grandparents is gone. Those now entering retirement generally do so with a mortgage, credit card debt, and little intention of cutting back on their spending. As a result, they often go through their retirement savings in the first ten years of retirement, leaving them in poverty for their remaining years. Women fare the worse since they tend to outlive their older male partners. Once the male partner dies any income that was exclusively his goes with him; the remaining female faces a double whammy: too little saved and diminished income.

Besides saving too little, many people also fail to properly diversify. While the employer’s stock may seem impressive, it would be a mistake to only save through that avenue, for example. A 401(k) plan should always be maxed out if there are matching funds available before using other financial vehicles, but other financial vehicles should be used at some point in addition to the 401(k) plan. Retirement planning should start early enough to be a long-term investing project. That allows employees time to weather bear markets (when prices go down) as well as enjoy bull markets (when prices go up). If a lump sum distribution is received from a pension plan due to retirement or a job loss, the entire sum should be rolled immediately into another retirement plan or long-term investment, such as an annuity. The employee should never, ever spend it in part or whole because his or her retirement years will require the entire amount to survive comfortably. Unfortunately, the statistics tell us that less than 15 percent of those who receive lump sum distributions roll the entire amount into another financial vehicle. Most either spend part of it before re-investing the remainder or they spend all of it, reinvesting nothing for their retirement.

Although the 401(k) plan seems to have originated more by accident than design, the IRS is very aware of their existence. On the subject of 401(k) plans, the IRS States:

“**Topic 424 - 401(k) Plans**

A section 401(k) plan is a type of tax-qualified deferred compensation plan in which an employee can elect to have the employer contribute a portion of his or her cash wages to the plan on a pretax basis. These deferred wages (commonly referred to as elective deferrals) are not subject to income tax withholding at the time of deferral, and they are not reflected on the employee’s Form 1040 since they were not included in the taxable...
wages on the employee’s Form W-2. However, the funds are included as wages subject to social security, Medicare, and federal unemployment taxes.

The amount that an employee may elect to defer to a 401(k) plan is limited. Therefore, your elective contributions may be limited based on the terms of your 401(k) plan. Refer to Publication 525, Taxable and Nontaxable Income, for more information about elective deferrals. Employers should refer to Publication 560, Retirement Plans for Small Business, for information about setting up and maintaining retirement plans for employees, including 401(k) plans.

Distributions from a 401(k) plan may qualify for optional lump–sum distribution treatment or rollover treatment as long as they meet the respective requirements. For more information, refer to Topic 412 (see below), Lump-Sum Distributions, and Topic 413 (see below), Rollovers from Retirement Plans.

Many 401(k) plans allow employees to make a hardship withdrawal because of immediate and heavy financial needs. Generally, hardship distributions from a 401(k) plan are limited to the amount of the employees' elective deferrals only, and do not include any income earned on the deferred amounts. Hardship distributions are not treated as eligible rollover distributions.

Distributions received before age 59 1/2 are subject to an early distribution penalty of 10% additional tax unless an exception applies. For more information about the treatment of retirement plan distributions, refer to Publication 575, Pension and Annuity Income.

**Topic 412 - Lump–Sum Distributions**

If you receive a lump–sum distribution from a qualified retirement plan or a qualified retirement annuity and the plan participant was born before January 2, 1936, you may be able to elect optional methods of figuring the tax on the distribution. These optional methods can be elected only once after 1986 for any eligible plan participant.

A lump–sum distribution is the distribution or payment, within a single tax year, of a plan participant's entire balance from all of the employer's qualified pension, profit-sharing, or stock bonus plans. All participant's accounts under the employer's qualified pension, profit-sharing, or stock bonus plans must be distributed in order to be a lump-sum distribution.

If the lump–sum distribution qualifies, you can elect to treat the portion of the payment attributable to your active participation in the plan using one of five options. (1) Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and the part from participation after 1973 as ordinary income. (2) Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and use the 10-year tax option to figure the tax on the part from participation after 1973.
(if you qualify). (3) Use the 10-year tax option to figure the tax on the total taxable amount (if you qualify). (4) Roll over all or part of the distribution. No tax is currently due on the part rolled over. Report any part not rolled over as ordinary income. (5) Report the entire taxable part as ordinary income.

You should receive a Form 1099-R from the payer of the lump-sum distribution showing your taxable distribution and the amount eligible for capital gain treatment. If you do not receive Form 1099–R by January 31st you should contact the payer of your lump–sum distribution.

You may defer tax on all or part of a lump–sum distribution by requesting that your employer directly roll over the taxable portion into an Individual Retirement Arrangement (IRA) or to an eligible retirement plan. You can also defer tax on a distribution paid to you by rolling over the taxable amount to an IRA within 60 days after receipt of the distribution. A rollover, however, eliminates the possibility of any future special tax treatment of the distribution. Refer to Topic 413 for more information on rollovers. Mandatory income tax withholding of 20% applies to most taxable distributions paid directly to you in a lump- sum from employer retirement plans regardless of whether you plan to roll over the taxable amount within 60 days.

For more information on the rules for lump–sum distributions, including information on distributions that do not qualify for the 20% capital gain election or the 10-year tax option, refer to Publication 575, Pension and Annuity Income, and to Form 4972, Instructions, Tax on Lump–Sum Distributions. Information is also available in Publication 17, Your Federal Income Tax.

**Topic 413 - Rollovers from Retirement Plans**

A rollover occurs when you withdraw cash or other assets from one eligible retirement plan and contribute all or part of it within 60 days to another eligible retirement plan. This transaction is not taxable but it is reportable on your Federal Tax Return. You can roll over most distributions except for:

1. The nontaxable part of a distribution, such as your after-tax contributions to a retirement plan (in certain situations after-tax contributions can be rolled over),

2. A distribution that is one of a series of payments based on your life expectancy or the joint life expectancy of you and your beneficiary or paid over a period of ten years or more,

3. A required minimum distribution,

4. A hardship distribution,

5. Dividends on employer securities, or
6. The cost of life insurance coverage.

Further exclusions exist for certain loans and corrective distributions.

Any taxable amount that is not rolled over must be included as income in the year of the distribution.

If a distribution is paid to you, you have 60 days from the date you receive it to roll it over. Any taxable distribution paid to you is subject to a mandatory withholding of 20%, even if you intend to roll it over later. If you do roll it over, and want to defer tax on the entire taxable portion, you will have to add funds from other sources equal to the amount withheld. You can choose to have your employer transfer a distribution directly to another eligible plan or to an IRA. Under this option, the 20% mandatory withholding does not apply.

If you are under age 59½ at the time of the distribution, any taxable portion not rolled over may be subject to a 10% additional tax on early distributions. Certain distributions from a SIMPLE IRA will be subject to a 25% additional tax. For more information on SIMPLE IRAs, refer to Publication 590, Individual Retirement Accounts.

Funding

As we know, a 401(k) plan is a retirement savings vehicle that is funded by employee contributions and may receive matching or partially matching contributions from the employer. The major attraction of these plans is that the contributions are taken from pre-tax salary, and the funds grow tax-free until withdrawn. To some extent the 401(k) plans are self-directed and portable. Both for-profit and many types of tax-exempt organizations can establish these plans for their employees.

It is the tax code that created 401(k) plans and it is the tax code that determines the rules and regulations for them. Its name is derived from the section of the Internal Revenue Code of 1978 that created them. Although the IRS determines the rules and regulations governing 401(k) plans, the operation of them are regulated by the Employee Benefits Security Administration of the U.S. Department of Labor. The 401(k) plan is actually a plan qualified under Section 401(a) of the Internal Revenue Code. Section 401(a) is the section that defines qualified plan trusts in general, including the various rules required for qualifications. Section 401(k) provides for an optional "cash or deferred" method of getting contributions from employees; therefore, every 401(k) plan already is a 401(a) plan.

Although the average person might assume that matching employer 401(k) contributions will be in the form of cash that is not always the case. Some company plans pay in company stock rather than cash. This is not necessarily a bad thing since the stock has
the potential of growing greater than might be the case with interest earnings, but as is always the case with stocks, they could also lose value.

Although companies initially were wary of 401(k) plans when they were first created (companies were concerned with their tax treatment and there was initially no track record to consult) as these issues became clearer, people quickly recognized the advantages of the tax-deferred vehicle. A primary advantage was the employees’ ability to contribute to his or her 401(k) plan with pre-tax money, which reduced taxes paid out of each paycheck. Additionally, the accumulating funds grow tax-free until withdrawn. The compounding effect of consistent periodic contributions over 20 or 30 years without taxation allows for maximum growth. The investor can decide where to direct future contributions and/or current savings, giving much control over the investments to the employee; some argue that this lends to investing errors, but many workers are savvy investors and do an adequate job. Also many companies have an individual available to lend investing advice and product information.

If the company matches the investor’s contributions, as we have previously stated, it amounts to getting free money on top of the worker’s salary. This alone makes it worthwhile to invest in the company’s 401(k) plan, with the goal of contributing the maximum amount allowed. Unlike traditional pension plans, all 401(k) plan contributions may be moved from one company’s plan to another (or to an IRA) if an investor loses his job or changes jobs. Since the plan is a personal investment program designed for retirement, it is protected by pension (ERISA) laws. This includes the additional protection provided to pensions from garnishment or attachment by creditors or assigned to anyone else, except in the case of domestic relations court cases dealing with divorce decree or child support orders (QDROs; i.e., qualified domestic relations orders).

Although the 401(k) plan is similar in nature to an IRA, the Individual Retirement Account will not receive matching company contributions, and personal IRA contributions are subject to much lower limits. The IRA limits have been raised from the original amount allowed, but the 401(k) is still likely to have higher limits.

As with all financial vehicles, there are some disadvantages with 401(k) plans:

First, it is difficult and potentially expensive to access the 401(k) funds prior to age 59½. This is not surprising since the goal is retirement funding; if it were easy to withdraw funds investors would likely do so, defeating the very purpose of the account.

Second, 401(k) plans don't have the luxury of being insured by the Pension Benefit Guaranty Corporation (PBGC). It should be noted, however, that not all pension plans are protected by the PBGC either.

Third, employer matching contributions are usually not immediately vested.
Why are the employer’s contributions not immediately vested? The money the company contributes does not belong to that employee until a specified number of years have passed. The rules say that employer matching contributions must vest according to one of two schedules: either a three-year "cliff" plan (100% after three years) or a six-year "graded" plan (twenty percent per year in years two through six). Despite these disadvantages, however, 401(k) plans have generally performed well for investors.

Investors usually get to choose how their 401(k) money is invested, within the options offered by their employer. Typically the options offered are a menu of mutual funds, such as money market funds, bond funds of varying maturities (short, intermediate, long-term), and various stock funds. Some plans may allow investments in company stock, US Series EE Savings Bonds, or other types of financial vehicles. The employee chooses how to invest the savings and is typically allowed to change where current savings are invested and/or where future contributions will go a specific number of times a year, such as monthly or quarterly. Generally, the employee may stop contributions at any time.

With respect to participant's choice of investments, professionals often say the average 401(k) participant is not aggressive enough with their investment options. Historically, stocks have outperformed all other forms of investment and will probably continue to do so. Since the investment period of 401(k) plans is relatively long (if the worker began as soon as the 401(k) plan was available) the length of the investment time (twenty to forty years) would minimize the risks associated with the stock market and allow a "buy and hold" strategy to pay off. As the investor nears retirement, he or she might want to switch to more conservative funds to preserve the plan’s value.

Puzzling out the rules and regulations for 401(k) plans is difficult simply because every company's plan is different. The law requires lower paid employees to participate in sufficient numbers when compared to higher paid employees. If lower paid employees do not contribute enough by the end of the plan year, then the limit is changed for highly compensated employees. The employer sets a maximum percentage of gross salary in order to prevent highly compensated employees from reaching the limits. The employer chooses how much to match, how much employees may contribute, and so forth. Obviously the IRS has the final say, so there are certain regulations that apply to all 401(k) plans equally.

401(k) Plan Contributions

Employees have the option of making all or part of their 401(k) plan contributions from gross income (prior to taxation). This has the added benefit of reducing the amount of tax paid by the employee from each check now and deferring it until the person takes the pre-tax money out of their plan. Employer contributions (if applicable) and accumulated interest earnings continue to compound tax-deferred, meaning no taxes will be due until the funds are withdrawn. According to the Department of Labor regulations, these contributions must be deposited rapidly, within a few business days after the end of the...
month in which they were made. This protects the investors, preventing companies from delaying deposits in order to gain interest earnings for the company, for example.

The rules govern what happens regarding before-tax and after-tax contributions. The IRS limits pre-tax deductions to a fixed dollar figure that changes annually. This means a 401(k) investor can only reduce his or her gross pay up to a specified fixed dollar maximum via contributions to his or her 401(k) plan. An employer's plan may place restrictions on the employees that are stricter than the IRS limit.

After-tax contributions are different than pre-tax contributions. If an employee elects to make after-tax contributions, the money comes out of net pay, meaning after taxes have been deducted. While it doesn't help the employee's current tax situation, funds that were contributed on an after-tax basis may be easier to withdraw since they are not subject to the strict IRS rules that apply to pre-tax contributions. When distributions begin the employee pays no tax on the portion of the distribution attributed to after-tax contributions, but does have to pay tax on any gains realized.

The IRS limits the amount of pay that may be contributed to a 401(k) plan. These limits change from year to year so we will not list them in this course. Individuals should consult a financial planner or tax specialist for exact details. It is always important to know the current 401(k) plan contribution limits to prevent excessive contributions. This figure indicates only the maximum amount that the employee can contribute from his or her pre-tax earnings to all of his or her 401(k) accounts combined. It does not include any matching funds that the employer might contribute. The maximum figure is not reduced by monies contributed towards many other plans, such as an IRA. If the individual works for two or more employers during the year, it is his or her responsibility to make sure contributions do not exceed the maximum amount allowed. If the employee inadvertently contributes more than the pre-tax limit into his or her 401(k) account, the employee must contact the employer. The excess might be refunded, or might be reclassified as an after-tax contribution.

The maximum before-tax contribution limit is subject to the catch-up provision, which is available to employees who are over 50 years old. This provision allows older employees to contribute extra amounts over and above the limit currently in effect for that year. The amount of “catch up” contribution changes, so once again, it is necessary to consult with a professional for the current amounts allowed. Older Americans should pay the maximum contribution allowed by law if at all possible.

Highly compensated employees also face 401(k) contribution regulations. Initially the government was concerned that executives would make their company’s 401(k) plans advantageous to themselves without allowing lower paid employees to receive the same benefits. The definition of “highly compensated” is determined by Internal Revenue Code (IRC), which specifies specific dollar amount compensation requirements, preventing companies from including those with lower pay within the definition.
Lawmakers decided executives needed an incentive to make 401(k) plans something lower compensated employees would want to participate in. Highly compensated employees are not allowed to save at the maximum rates. The company will still determine who is classified as “highly compensated” (within IRS guidelines) so there will be variations from company to company.

IRS regulations include what is referred to as "415 limits." Contributions can only be made on wages up to specified amounts, which change annually. The IRS further limits the total amount for defined contribution plans, such as 401(k) plans, 401(a) plans, and pension plans each year to the lesser of 100% of annual compensation, or a predetermined dollar amount. The specified dollar amount changes periodically so it is necessary to consult a specialist for the current figure. Annual compensation is defined as gross compensation for the purpose of computing the limitation. This is a change from an earlier law; a person's annual compensation for the purpose of this computation is no longer reduced by 401(k) contributions and salary redirected to cafeteria benefit plans.

Unlike IRA or other retirement-saving accounts, 401(k) plans allow limited, penalty-free access to savings prior to age 59½. In effect, the investor is taking a loan from him or herself since it is legal to take a loan from his or her 401(k) plan prior to age 59½. The tax code is not specific as to what loans are permitted, just that loans must be made reasonably available to all participants. However, the employer can restrict loans to specific needs, such as covering un-reimbursed medical expenses, buying a home, or paying for education. Once the loan is obtained the individual must repay the loan through regular payments, which can be set up as payroll deductions. The investor, as with any loan, must repay both principal and interest but in this case he or she is repaying the loan to him or herself. If the investor withdraws money that is not a loan from their 401(k) plan (they do not intend to repay it, in other words), not only must he or she pay tax on any pre-tax contributions and the growth, he or she must also pay an additional 10% penalty to the government. There are special conditions that permit withdrawals at various ages without penalty; an expert should be consulted for exact details.

There are varying opinions as to whether or not an investor should use their 401(k) plan monies for any purpose other than retirement. Does it make sense for an investor to ever take a loan from his or her 401(k) plan? As with most things, there are both advantages and disadvantages to doing so. The individual investor will need to assess their personal situation and hopefully make an informed decision. Certainly it is convenient to withdraw from one’s 401(k) plan since there is no credit check or approval process, but that should never be the primary reason funds are withdrawn from the plan. The interest rate is usually just a few points over the prime rate, although the investor is repaying the rate of interest to him or herself anyway.

Disadvantages include the loss of interest earnings on any money withdrawn from the 401(k) plan and there may also be fees involved. Additionally, the loan must be repaid
immediately if the investor changes jobs. A loan default (failing to repay the loan) is treated as an early withdrawal with all applicable taxes and penalties due. Since few people have absolute job security, there are considerable risks involved with loans taken against 401(k) plans.

Once vesting in the 401(k) plan has occurred, investors can begin to withdraw their savings without withdrawal penalties at various ages, depending on the plan and personal circumstances. An investor who leaves his or her job at age 55 or more during the year of separation may withdraw any amount from his or her 401(k) plan without any calculated minimums and without any 5-year rules. Depending on the plan, a participant may be able to withdraw funds without penalty at or after age 59½, regardless of whether he or she is still employed. It is important to check with the plan administrator to be certain of such rules or requirements. The minimum withdrawal rules for participants who are no longer employed begin at age 70½. If the investor is age 55 or more, being able to draw any amount of money and for any length of time without penalty after leaving the job is one of the least understood differences between 401(k) plans and IRAs. Whether or not the investor is officially “retired” is not relative to 401(k) plans.

Individuals who no longer work for the company offering the 401(k) plan, and who is entitled to withdraw funds without penalty, may take a lump sum withdrawal. Until 1999, the tax laws allowed people to use an income averaging method to spread that lump sum over five years for tax purposes, but that option is no longer available. The entire withdrawal must be reported to the IRS as income in the year the withdrawal was taken. It is not necessary to make a full withdrawal since the entire 401(k) account can be transferred directly to an IRA custodian, allowing the account will continue to grow tax deferred.

Like IRA’s, participants in 401(k) plans must start taking distributions by age 70½. The Internal Revenue Service imposes a minimum annual distribution on 401(k) plans at age 70½; taxes will be due on amounts withdrawn. There is an exception, however, to the minimum and required distribution rules: if the individual continues to work for the same company that sponsors the 401(k) plan, he or she does not have to start withdrawing from their 401(k) plan.

Since 401(k) plans are company-administered (and every plan is different) changing jobs could significantly affect the 401(k) plan. Each company will handle this situation according to their personal guidelines; some companies will allow the investor to keep his or her savings in the program until age 59½. If this is available, it may be the easiest way to handle the 401(k) plan. Some companies will require the investor to withdraw their money when they leave employment, which will then be more complicated. The new company may allow a "rollover" contribution to its 401(k) plan, which would allow the investor take all the 401(k) savings from his or her old job and put them into the new company's plan. If this is not a possibility, the investor could elect to roll over his or her funds into an IRA instead of another 401(k) plan. However, as we noted, a 401(k) plan
has several advantages over an IRA, so most professionals would prefer to roll the money into another 401(k) plan if possible.

Anytime money is rolled from one plan to another it is very important to do it properly to avoid errors that may result in withdrawal penalties. It is best to make a direct rollover, meaning the money goes from one plan to another without every resting in the investor’s hands. Because the investor never touches the money, no tax is withheld or owed on the direct rollover amount.

If the direct rollover option is not chosen, meaning the money rests in the investor’s hands, the withdrawal is immediately subject to a mandatory tax withholding of the taxable portion, which the old company must send to the IRS. The remaining amount must be rolled over within 60 days to a new retirement account; otherwise it is subject to a 10% tax. The mandatory withholding at the time of withdrawal is designed to cover any possible taxes due, but it can be recovered using a special form filed with the investor’s next tax return to the IRS. If the investor fails to file that form, however, the mandatory tax withholding is lost.

Important notice: the mandatory tax withholding that was withheld when the 401(k) funds were withdrawn from the first plan must also be rolled into a new retirement account within 60 days, out of the investor’s own pocket, or it will be considered withdrawn and subject to the 10% tax. The investor should check with his or her benefits department prior to performing any type of rollover of 401(k) funds.

To demonstrate the rollover that did not utilize a direct rollover, consider the following example:

Ernest Employee changed jobs. He had $10,000 in his company’s 401(k) plan when his job ended with ABC Corporation. Because he did not utilize a direct rollover, the 401(k) money will temporarily rest in his hands. Ernest receives $8,000 of the $10,000 he had in his 401(k) plan at ABC Corporation. The IRS will receive $2,000 from his employer against possible taxes on his withdrawal. To maintain tax-exempt status on the entire amount, Ernest must deposit $10,000 into XYZ Corporation’s retirement plan within 60 days of the withdrawal date, even though he only received $8,000 of the $10,000 he had in the original 401(k) plan. As we know, Ernest Employee only has $8,000 in hand; if he is not able to obtain the remaining $2,000 until he files his taxes at the end of the year, what can he do? Ernest can:

1. Borrow $2,000 from a bank or friend so he can deposit the entire $10,000, or
2. Roll over just the $8,000 he has in his hands. The remaining $2,000 then loses its tax status and will incur income tax and a 10% penalty tax.

Obviously a direct rollover would have been advantageous for Ernest Employee. It should be noted that if Ernest had been in an employee contribution retirement plan prior

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to 1986, some of the rules may be different on those funds invested before 1986. He should consult with his benefits department for exact details.

The rules changed at the end of 1999 to disallow income averaging of lump-sum withdrawals over five years. Ten-year income averaging is available only to those born before January 2, 1936. Any amount withdrawn will be taxed along with other existing income. If the investor could withdraw funds over several years it might reduce the total tax by keeping him or her out of a higher tax bracket. As always, it is wise to consult with a tax specialist if a lump sum distribution is being considered.

401 (k) Tax consequences

Most 401(k) contributions are made on a pre-tax basis. Starting in the 2006 tax year, employees can either contribute on a pre-tax basis or opt to utilize the Roth 401(k) provisions to contribute on an after-tax basis and have similar tax effects of the Roth IRA. In order to do that, however, the plan sponsor must amend the plan to make those options available. Whether pre-tax or after-tax contributions are chosen, earnings from investments in a 401(k) account (in the form of interest, dividends, or capital gains) are not taxable events. The resulting compound interest without taxation can be a major benefit of the 401(k) plan.

For pre-tax contributions, the employee does not pay federal income tax on the amount of current income that he or she defers to a 401(k) account. For example, a worker who earns $50,000 that year but defers $3,000 into a 401(k) account only pays taxes on $47,000 for the year's tax return. The employee will eventually pay taxes on the diverted money but not until he or she withdraws the funds, generally during retirement. The gains (including tax favored capital gains) are transformed into "ordinary income" at the time the money is withdrawn.

For after-tax contributions to a Roth 401(k), qualified distributions can be made tax free. To qualify, distributions must be made more than 5 years after the first designated Roth contributions and not before the year in which the account owner turns age 59½, unless an exception applies as detailed in IRS code section 72(t). In the case of designated Roth contributions, the contributions being made on an after tax basis means that the taxable income in the year of contribution is not decreased as it is with pre-tax contributions. Roth contributions are irrevocable and cannot be converted to pre-tax contributions at a later date. Administratively Roth contributions must be made to a separate account, and records must be kept that distinguish the amount of contribution that are to receive Roth treatment.

Fund Withdrawals

Virtually all employers impose severe restrictions on withdrawals while a person remains in service with the company and is under age of 59½. Any withdrawal that is
permitted before the age of 59½ is subject to an excise tax equal to ten percent of the amount distributed, including withdrawals to pay expenses due to a hardship, except to the extent the distribution does not exceed the amount allowable as a deduction under Internal Revenue Code section 213 to the employee for amounts paid during the taxable year for medical care (determined without regard to whether the employee itemizes deductions for such taxable year).

In any event any amounts are subject to normal taxation as ordinary income. Some employers may disallow one, several, or all of the previous hardship causes. Someone wishing to withdraw from a 401(k) plan would have to resign from their employer. To maintain the tax advantage for income deferred into a 401(k), the law stipulates the restriction that unless an exception applies, money must be kept in the plan or an equivalent tax deferred plan until the employee reaches age 59½. Money that is withdrawn prior to age 59½ typically incurs a 10% penalty tax unless a further exception applies. This penalty is on top of the "ordinary income" tax that has to be paid on the withdrawal. Exceptions to the 10% penalty include the employee's death, the employee's total and permanent disability, separation from service in or after the year the employee reached age 55, substantially equal periodic payments under section 72(t), a qualified domestic relations order, and for deductible medical expenses (exceeding the 7.5% floor). This does not apply to the similar 457 plan.

Many plans also allow employees to take loans from their 401(k) to be repaid with after-tax funds at pre-defined interest rates. The interest proceeds then become part of the 401(k) balance. The loan itself is not taxable income nor subject to the 10% penalty as long as it is paid back in accordance with section 72(p) of the Internal Revenue Code. This section requires, among other things, that the loan be for a term no longer than 5 years (except for the purchase of a primary residence), that a "reasonable" rate of interest be charged, and that substantially equal payments (with payments made at least every calendar quarter) be made over the life of the loan. Employers, of course, have the option to make their plan's loan provisions more restrictive. When an employee does not make repayments in accordance with the plan or IRS regulations, the outstanding loan balance will be declared in “default.” A defaulted loan, and possibly accrued interest on the loan balance, becomes a taxable distribution to the employee in the year of default with all the same tax penalties and implications of a withdrawal.

These loans have been described as tax-disadvantaged, on the theory that the 401(k) contains before-tax dollars, but the loan is repaid with after-tax dollars. This is not correct. The loan is repaid with after-tax dollars, but the loan itself is not a taxable event, so the "income" from the loan is tax-free. This treatment is identical to that of any other loan, as long as the balance is repaid on schedule. (A residential mortgage or home equity line of credit may have tax advantages over the 401(k) loan; but that is because the interest on home mortgages is deductible, and unrelated to the tax-deferred features of the 401(k).)
Minimum Distributions Required

An account owner must begin making distributions from their accounts at least no later than the year after the year the account owner turns 70½ unless the account owner is still employed at the company sponsoring the 401(k) plan. The amount of distributions is based on life expectancy according to the relevant factors from the appropriate IRS tables. The only exception to minimum distribution are for people still working once they reach that age, and the exception only applies to the current plan they are participating in. Required minimum distributions apply to both pre-tax and after-tax Roth contributions. Only a Roth IRA is not subject to minimum distribution rules. Other than the exception for continuing to work after age 70½, 401(k) plans differ from the rules for IRA minimum distributions. The same penalty applies to the failure to make the minimum distribution. The penalty is 50% of the amount that should have been distributed, one of the most severe penalties the IRS applies. In response to the economic crisis, Congress suspended the RMD requirement for 2009.

There is a maximum limit on the total yearly employee pre-tax salary deferral. The limit, known as the “401(k) limit,” may change from year to year; it is always important to know the current limit. The limit may be indexed for inflation, increasing in increments of $500. Employees who are 50 years old or more at any time during the year are allowed additional pre-tax "catch up" contributions. The limit for future "catch up" contributions may also be adjusted for inflation in increments of $500. In eligible plans, employees can elect to have their contribution allocated as either pre-tax contributions or as after-tax Roth 401(k) contributions, or a combination of the two. The total of all 401(k) contributions must not exceed the maximum contribution amount.

If the employee contributes more than the maximum pre-tax limit to 401(k) accounts in a given year, the excess must be withdrawn by April 15 of the following year. This violation most commonly occurs when a person switches employers mid-year and the latest employer does not know to enforce the contribution limits on behalf of their employee. If this violation is noticed too late, the employee may have to pay taxes and penalties on the excess. The excess contribution, as well as the earnings on the excess, is considered "non-qualified" and cannot remain in a qualified retirement plan such as a 401(k).

Plans that are set up under section 401(k) can also have employer contributions that (when added to the employee contributions) cannot exceed other regulatory limits. The total amount that can be contributed between employee and employer contributions is the section 415 limit, which is the lesser of 100% of the employee's compensation or a specified amount. Since the dollar amount changes, a tax attorney should be consulted. Employer matching contributions can be made on behalf of designated Roth contributions, but the employer match must be made on a pre-tax basis.
Governmental employers in the US (that is, federal, state, county, and city governments) are currently barred from offering 401(k) plans unless they were established before May 1986. Governmental organizations instead can set up a section 457(g).

**Highly Compensated Employees (HCE)**

To help ensure that companies extend their 401(k) plans to low-paid employees, an IRS rule limits the maximum deferral by the company's “highly compensated” employees, based on the average deferral by the company's non-highly compensated employees. If the rank and file saves more for retirement, then the executives are allowed to save more for retirement. This provision is enforced through what is called “non-discrimination testing.” Non-discrimination testing takes the deferral rates of highly compensated employees (HCE) and compares them to non-highly compensated employees (NHCE).

**401(k) Plans for Small Businesses or Sole Proprietorships**

Many financial advisors self-employed individuals felt that 401(k) plans did not meet the needs of small business owners. The high costs, difficult administration, and low contribution limits were difficult for the self-employed and sole proprietorships. The *Economic Growth and Tax Relief Reconciliation Act of 2001* (EGTRRA) made 401(k) plans more beneficial for the self-employed. The two key changes enacted related to the allowable “Employer” deductible contribution, and the “Individual” IRC-415 contribution limit.

401(k) plans can be a powerful tool in promoting financial security in retirement. They are a valuable option for businesses considering a retirement plan, providing benefits to employees and their employers. Employers start a 401(k) for a many reasons. A well-designed 401(k) plan attracts talented employees so offering such a plan becomes an incentive to key personnel. It allows participants to decide how much to contribute to their accounts on a before-tax basis. Employers are entitled to a tax deduction for their contributions to employees’ accounts, but it also benefits the rank-and-file employees.

The money contributed may grow through investments in stocks, mutual funds, money market funds, savings accounts, and other investment vehicles. Contributions and earnings generally are not taxed by the Federal government or by most State governments until they are distributed. A 401(k) plan may allow participants to take their benefits with them when they leave the company, easing administrative burdens.

As of 2006, 401(k) plans can be established or amended to permit employees to designate some or all of their contributions (employee deferrals) as Roth contributions. These contributions are made on an after-tax basis, but distributions (including earnings) are tax-free (if certain conditions are met).
Initial Actions

There are four basic steps to set up a 401(k) plan:

1. **Adopt a written plan**

   Plans begin with a written document that serves as the foundation for day-to-day plan operations. If the plan provider has hired someone to help with the plan, that person will probably provide the written document. If not, assistance may often be obtained from a financial institution or retirement plan professional. Since the business is bound by the terms of the plan document it is very important to set it up correctly and appropriately.

   Before beginning the plan document, however, the business owner will need to decide on the type of 401(k) plan that is best for the situation: a traditional 401(k), a safe harbor 401(k), or a SIMPLE 401(k) plan.

   A **traditional 401(k) plan** offers the maximum flexibility of the three types of plans. Employers have discretion to make contributions on behalf of all participants, to match employees’ deferrals, or do both. These contributions can be subject to a vesting schedule (which provides that an employee’s right to employer contributions becomes non-forfeitable only after a period of time). In addition, a traditional 401(k) allows participants to make pre-tax contributions through payroll deductions. Annual testing ensures that benefits for rank and file employees are proportional to benefits for owners/managers.

   A **safe harbor 401(k) plan** is similar to a traditional 401(k) plan, but, among other things, must provide for employer contributions that are fully vested when made. However, the safe harbor 401(k) is not subject to many of the complex tax rules that are associated with a traditional 401(k) plan, including annual nondiscrimination testing. Both the traditional and safe harbor plans are for employers of any size and can be combined with other retirement plans.

   A **SIMPLE 401(k) plan** was created so that small businesses could have an effective cost-efficient way to offer retirement benefits to their employees. A SIMPLE 401(k) plan is not subject to the annual nondiscrimination tests that apply to the traditional plans. Similar to a safe harbor 401(k) plan, the employer is required to make employer contributions that are fully vested. This type of 401(k) plan is available to employers with 100 or fewer employees who received at least $5000 in compensation from the employer for the preceding calendar year. In addition, employees that are covered by a SIMPLE 401(k) plan may not receive any contributions or benefit accruals under any other plans of the employer.

   Once the business has decided on the type of plan for their company, they will have flexibility in choosing some of the plan’s features, such as which employees can
contribute to the plan and how much. Other features written into the plan are required by law. For example, the plan document must describe how certain key functions are carried out, such as how contributions are deposited in the plan.

(2) **Arrange a trust fund for the plan’s assets**

A plan’s assets must be held in trust to assure that assets are used solely to benefit the participants and their beneficiaries. The trust must have at least one trustee to handle contributions, plan investments, and distributions to and from the 401(k) plan. Since the financial integrity of the plan depends on the trustee, this is one of the most important decisions made in establishing the 401(k) plan. If the plan is set up through insurance contracts, the contracts do not need to be held in trust.

(3) **Develop a recordkeeping system**

An accurate record keeping system helps track and properly attribute contributions, earnings and losses, plan investments, expenses, and benefit distributions in participants’ accounts. If there is a contract administrator or financial institution assisting in managing the plan, that entity typically will help in keeping the required records. In addition, a record keeping system will help the employer, the plan administrator, or financial provider prepare the plan’s annual return/report that must be filed with the Federal government.

(4) **Provide plan information to eligible employees**

As the 401(k) plan is put in place, the employer must notify employees who are eligible to participate in the plan about the plan’s benefits and requirements. A summary plan description or SPD is the primary vehicle to inform participants and beneficiaries about the plan and how it operates. The SPD typically is created with the plan document. The employer will need to send it to all plan participants. In addition the employer may want to provide their employees with information that discusses the advantages of joining the company’s 401(k) plan. Employee perks, such as pre-tax contributions to a 401(k) plan (or tax-free distributions in the case of Roth 401(k)s), employer contributions if available, and compounded tax-deferred earnings help highlight the advantages of participating in the plan.

Once the business has established a 401(k) plan, it assumes certain responsibilities in operating the plan. If someone was hired to help in setting up your plan, that arrangement may have included help in operating the plan. If not, another important decision will be whether to manage the plan or hire a professional or financial institution such as a bank, mutual fund provider, or insurance company to take care of some or most aspects of operating the plan. Elements of a plan that need to be handled include:

- Participation
• Contributions
• Vesting
• Nondiscrimination
• Investing 401(k) Monies
• Fiduciary Responsibilities
• Disclosing Plan Information To Participants
• Reporting To Government Agencies
• Distributing Plan Benefits

Participation

Typically, a plan includes a mix of rank-and-file employees and owner/managers. However, some employees may be excluded from a 401(k) plan if they:

• Have not attained age 21;
• Have not completed a year of service; or
• Are covered by a collective bargaining agreement that does not provide for participation in the plan, if retirement benefits were the subject of good faith bargaining.

Employees cannot be excluded from a plan merely because they are older workers.

Contributions

Another design option when establishing and operating a 401(k) plan is deciding on whether or not the business will make a contribution to participants’ accounts (matching funds). The company could match in part or whole the amount contributed by the employees. If a match is made, the company will likely want to state a maximum amount it will match per employee per year.

Traditional 401(k) Plan

If the company decides to contribute to their employee’s 401(k) plans, there are further options. The employer can contribute a percentage of each employee’s compensation for allocation to the employee’s account (called a non-elective contribution), or the company can match the amount the employees decide to contribute (within the limits of current law) or you can do both.
If the company decides to add a percentage, such as 50 percent, to each employee’s contribution that results in a 50-cent increase for every dollar the employee sets aside. Using a matching contribution formula will provide additional employer contributions only to employees who make deferrals to the 401(k) plan. If the employer decides to make non-elective contributions, the employer makes a contribution for each eligible participant, whether or not the participant decides to make a salary deferral to his or her 401(k) account.

Under a traditional 401(k) plan, there is usually the flexibility of changing the amount of non-elective contributions each year, according to business conditions.

**Safe Harbor 401(k) Plan**

Under a safe-harbor plan, the business can match each eligible employee’s contribution, dollar for dollar, up to 3 percent of the employee’s compensation, and 50 cents on the dollar for the employee’s contribution that exceeds 3 percent, but not 5 percent, of the employee’s compensation. Alternatively, the company can make a non-elective contribution equal to 3 percent of compensation to each eligible employee’s account. Each year the company must make either the matching contributions or the non-elective contributions.

**SIMPLE 401(k) Plan**

Employer contributions to a SIMPLE 401(k) plan are limited to either:
- A dollar-for-dollar matching contribution, up to 3 percent of pay; or
- A non-elective contribution of 2 percent of pay for each eligible employee.

No other employer contributions can be made to a SIMPLE 401(k) plan, and employees cannot participate in any other retirement plan of the employer. There are maximums that cannot be exceeded.

An additional catch-up contribution is allowed for employees aged 50 and over. The company should consult their tax advisor for the amounts allowed.

**Vesting**

Employee salary deferrals are immediately 100 percent vested. The money that an employee has put aside through salary deferrals cannot be forfeited. When an employee leaves employment, he or she is entitled to those deferrals, plus any investment gains (or minus losses) on their deferrals.

In SIMPLE 401(k) plans and safe harbor 401(k) plans, all required employer contributions are always 100 percent vested. In traditional 401(k) plans, the employer can
design their plan so that _employer contributions_ become vested over time, according to a vesting schedule.

**Nondiscrimination**

Realizing 401(k) plan tax benefits requires that plans provide substantive benefits for rank-and-file employees, not just for business owners and managers. These requirements are referred to as non-discrimination rules and cover the level of plan benefits for rank-and-file employees compared to owners/managers.

Traditional 401(k) plans are subject to annual testing to assure that the amount of contributions made on behalf of rank-and-file employees is proportional to contributions made on behalf of owners and managers. Safe harbor 401(k) plans and SIMPLE 401(k) plans are not subject to annual non-discrimination testing.

**Investing 401(k) Monies**

After deciding on the type of 401(k) plan, the company can consider the variety of investment options. One decision to make when designing a plan is whether to permit employees to direct the investment of their accounts or to manage the monies on their behalf. If the former is chosen, the company also needs to decide what investment options to make available to the participants. Depending on the plan design chosen, the company may want to hire someone either to determine the investment options to make available or to manage the plan’s investments. Continually monitoring the investment options ensures that selections remain in the best interests of the plan and its participants.

**Fiduciary Responsibilities**

Many of the decisions regarding 401(k) plans involve fiduciary duties. For example, should the company hire someone to manage the plan for the company or should it self-manage. Controlling the assets of the plan or using discretion in administering and managing the plan makes the company or the entity hired a plan fiduciary to the extent of plan discretion or control. As a result, fiduciary status is based on the functions performed for the plan, not a title. This is important, so to repeat: _fiduciary status is based on the functions performed – not the person’s title_. Be aware that hiring someone to perform fiduciary functions is itself a fiduciary act.

Some decisions with respect to a plan are business decisions rather than fiduciary decisions. For instance, the decision to establish the plan, to include certain features in a plan, to amend a plan and to terminate a plan is business decisions. When making these decisions, individuals are acting on behalf of the business rather than the plan, and therefore, is not a fiduciary function. However, when the company takes steps to
implement these decisions, it or those they hire are acting on behalf of the plan and therefore are acting as fiduciaries.

Individuals or entities that are fiduciaries are in a position of trust with respect to the participants and beneficiaries in the plan. The fiduciary's responsibilities include:

- Acting solely in the interest of the participants and their beneficiaries;
- Acting for the exclusive purpose of providing benefits to workers participating in the plan and their beneficiaries, and defraying reasonable expenses of the plan.
- Carrying out duties with the care, skill, prudence, and diligence of a prudent person familiar with such matters.
- Following plan documents;
- Diversifying plan investments.

These are the responsibilities that fiduciaries need to keep in mind as they carry out their duties. The responsibility to be prudent covers a wide range of functions and it is probably best to use persons or entities with past fiduciary responsibilities. Since all these functions must be carried out in the same manner as a prudent person would carry them out, it may be in your best interest to consult experts in the various fields, such as investments and accounting.

There are specific rules for some fiduciary duties that help guide the person or entity performing that job. For example, if the plan provides for salary reductions from employees’ paychecks for plan contribution, then these contributions must be timely deposited. The law states that this must be accomplished as soon as it is reasonably possible to do so, but no later than the 15th business day of the month following the payday. If the deposits could reasonably be made in a shorter time frame, that should be done.

**Limiting Fiduciary Liability**

With fiduciary responsibilities, there also comes some potential liability. However, there are actions a business can take to demonstrate that they carried out their responsibilities properly and also ways to limit liability.

The fiduciary responsibilities cover the process used to carry out the plan functions rather than simply the end results. For example, investments made by the employer or someone they hired would not mean investments must always be “winners” as long as those decisions were part of a prudent overall diversified investment portfolio for the plan. Since a fiduciary must carry out activities through a prudent process, he or she should document the decision-making process to demonstrate the rationale behind the decisions at the time they were made.
In addition to the steps above, there are other ways to limit potential liability. The plan can be set up to give participant’s control of the investments in their accounts. For participants to have control, they must have sufficient information on the specifics of their investment options. If properly executed, this type of plan limits the company’s liability for the investment decisions made by participants. The employer can also hire a service provider or providers to handle some or most of the fiduciary functions, setting up the agreement so that the person or entity then assumes liability.

**Hiring a Service Provider**

Even if the employer hires a financial institution or retirement plan professional to manage the whole plan, it still retains some fiduciary responsibility for the decision to select and keep that person or entity as the plan’s service provider. Obviously, this potential liability is a major reason companies use fiduciaries with past experience and training in retirement plans. The employer should document the selection process and monitor the services provided to determine if a change needs to be made, however.

Some items to consider in selecting a plan service provider:

- Information about the firm itself: affiliations, financial condition, experience with 401(k) plans, and assets currently under their control;
- A description of business practices: how plan assets will be invested if the firm will manage plan investments or how participant investment directions will be handled, and proposed fee structure;
- Information about the quality of prospective providers: the identity, experience, and qualifications of the professionals who will be handling the plan’s account; any recent litigation or enforcement action that has been taken against the firm; the firm’s experience or performance record; if the firm plans to work with any of its affiliates in handling the plan’s account; and whether the firm has fiduciary liability insurance.
- Once hired, these are additional actions to take when monitoring a service provider, including:
  - Review the service provider’s performance;
  - Read any reports they provide;
  - Check actual fees charged;
  - Ask about policies and practices (such as trading, investment turnover, and proxy voting); and
  - Follow up on participant complaints.
Prohibited Transactions and Exemptions

There are certain transactions that are prohibited under the law to prevent dealings with parties that have certain connections to the plan, self-dealing, or conflicts of interest that could harm the plan. However, there are a number of exceptions under the law, and additional exemptions may be granted by the U.S. Department of Labor, where protections for the plan are in place in conducting the transactions.

For example, there is an exemption that permits the employer to offer loans to participants through the plan. If the 401(k) plan does offer loans, the loan program must be carried out in such a way that the plan and all other participants are protected. So, the decision with respect to each loan request is treated as a plan investment and considered accordingly.

Bonding

Individuals handling plan funds or other plan property generally must be covered by a fidelity bond to protect the plan against fraud and dishonesty.

Disclosing Plan Information to Participants

Plan disclosure documents keep participants informed about the basics of plan operation, alert them to changes in the plan’s structure and operations, and provide them a chance to make decisions and take timely action with respect to their accounts.

Summary Plan Description (SPD)

The summary plan description is a basic descriptive document. It should be a simply stated explanation of the plan and must be comprehensive enough to apprise participants of their rights and responsibilities under the plan. It also informs participants about the features and what to expect. Among other things, the SPD must include information about:

- When and how employees become eligible to participate in the 401(k) plan;
- The contributions to the plan;
- How long it takes to become vested;
- When employees are eligible to receive their benefits;
- How to file a claim for those benefits; and
- Basic rights and responsibilities participants have under the federal retirement law, the Employee Retirement Income Security Act (ERISA).

The SPD should include an explanation about the administrative expenses that will be paid by the plan. This document must be given to participants when they join the plan.
and to beneficiaries when they first receive benefits. SPDs must also be redistributed periodically during the life of the plan.

**Summary of Material Modification (SMM)**
This summary apprises participants of changes made to the plan or to the information required to be in the SPD. The SMM or an updated SPD must be automatically furnished to participants within a specified number of days after the change.

**Individual Benefit Statement (IBS)**
The Individual Benefit Statement shows the total plan benefits earned by a participant and information on their vested benefits. The IBS must be provided when a participant submits a written request, but no more than once in a 12-month period, and automatically to certain participants who have terminated service with the employer. In addition, many plans choose to provide on a quarterly basis individual account statements that show the assets in a participant’s account, how it is invested, and any increases or decreases in investments during the period covered by the statement.

**Summary annual report (SAR)**
The SAR is a narrative of the plan’s annual return/report, and the Form 5500, filed with the Federal government. It must be furnished annually to participants.

**Blackout period notice**
This notice gives employees advance notice when a blackout period occurs, typically when plans change record keepers or investment options, or when plans add participants due to corporate mergers or acquisitions. During a blackout period, participants’ rights to direct investments, take loans, or obtain distributions are suspended.

**Reporting to Government Agencies**
In addition to the disclosure documents that provide information to participants, plans must also report certain information to government entities.

**Form 5500 Series**
Plans are required to file an annual return or report with the Federal government. Depending on the number and type of participants covered, most 401(k) plans must file one of the two following forms:

- Form 5500, *Annual Return/Report of Employee Benefit Plan*, or
- Form 5500-EZ, *Annual Return of One-Participant (Owners and Spouses) Retirement Plan*

For 401(k) plans, the Form 5500 is designed to disclose information about the plan and its operation to the IRS, the U.S. Department of Labor, plan participants, and the public.
Most one-participant plans (sole proprietor and partnership plans) with total assets of $100,000 or less are exempt from the annual filing requirement. A final return or report must be filed when a plan is terminated regardless of the value of the plan’s assets.

**Form 1099-R**

*Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.* is given to both the IRS and recipients of distributions from the plan during the year. It is used to report distributions (including rollovers) from a retirement plan. See Form 1099-R and the Form 1099-R and 5498 Instructions for additional information.

**Distributing Plan Benefits**

Benefits in a 401(k) plan are dependent on a participant’s account balance at the time of distribution.

When participants are eligible to receive a distribution, they typically can elect to:

- Take a lump sum distribution of their account,
- Roll over their account to an IRA or another employer’s retirement plan, or
- Purchase an annuity.

**Terminating a 401(k) Plan**

Although 401(k) plans must be established with the intention of being continued indefinitely, the employer may terminate the plan when it no longer suits the business needs. For example, the employer may want to establish another type of retirement plan in lieu of the 401(k) plan, so the 401(k) plan would be terminated.

Typically, the process of terminating a 401(k) plan includes amending the plan document, distributing all assets, and filing a final Form 5500. The company must also notify their employees that the 401(k) plan will be discontinued.

**Compliance**

Even with the best intentions, mistakes in plan operation can still happen. The U.S. Department of Labor and IRS have correction programs to help 401(k) plan sponsors correct plan errors, protect participants and keep the plan’s tax benefits. These programs are structured to encourage the employer to correct the errors early. Having an ongoing review program makes it easier to spot and correct mistakes in plan operations.
Simplified Employee Pension Plans (SEP)

Definition:
A SEP is a retirement plan that allows an individual to contribute and deduct up to 20 percent of self-employment income (25 percent of salary if you're an employee of your own corporation).

As its name implies, the Simplified Employee Pension Plan (SEP) is the simplest type of retirement plan available. Essentially, this is a glorified IRA that allows individuals to contribute a set percentage up to a maximum amount each year. The percentage can be varied each year, so lower amounts (or nothing at all) can be contributed when income is down. If cash is not available, nothing need be deposited to the SEP at all, even for the entire year.

Paperwork is minimal which is favored by many small companies. It is the employer that makes the contributions on the employee’s behalf. Unlike 401(k) plans, employees don't make any contributions to SEPs. Employers must pay the full cost of the plan, and whatever percentage is contributed for the business owner must also be contributed to all eligible employees. The maximum contribution is 15 percent of an employee's salary or the currently specified dollar amount, whichever is less.

SEPs are easy to establish and administer. They may be established with a bank, brokerage firm, or insurance company. No annual government reports are required, and there are no ongoing administrative expenses. SEPs are just as easy as deductible IRAs, but they allow much bigger contributions.

A simplified employee pension is an excellent option for employers who want an easy way to provide retirement savings for their employees. A SEP is basically just an individual retirement account, similar to the traditional IRA, and is often referred to as a SEP-IRA. The employer sets it up on behalf of each employee and pays into it for the employee. From the perspective of the SEP participant, a SEP-IRA is not much different from a traditional IRA, except that a SEP-IRA allows the participant to put away more money each year for retirement income.

Employers like SEP plans because they are easy to establish and inexpensive to administer. Under a SEP plan, the employer sets up a traditional IRA for each qualifying employee. Although an employer may adopt less restrictive participation requirements, an employer adopting a SEP plan must allow participation if an employee meets all of the following conditions:

- The employee is at least 21 years old.
The employee has worked for the employer during at least three of the five years immediately preceding the current year.

The employee has received at least minimum requirements for compensation from the employer.

An employer with leased employees may have to provide them with SEP-IRAs as well. A leased employee is generally a person who works for the employer, but was hired by a leasing organization. To qualify for SEP benefits, a leased employee must do all of the following:

- Provide services under an agreement between the employer and the leasing organization;
- Perform services for the employer, or for the employer and related persons, on a substantially full-time basis for at least one year;
- Perform services under the primary direction and control of the recipient;
- Although an employer adopting a SEP plan must include all eligible employees in the plan, the employer may exclude the following two types of employees:
  - Employees covered by a union agreement if their retirement benefits were a result of good faith bargaining between their union and the employer;
  - Nonresident alien employees who have no U.S. source earned income from their employer.

An employer may offer a SEP plan in conjunction with another defined contribution plan. Employees may also make additional contributions to their SEP-IRAs independent of the employer, but they are subject to the same restrictions imposed on traditional IRAs when contributions are simultaneously being made to a retirement plan. Plan distribution is the same for SEP plans as for IRAs because they are essentially the same thing.

Simplified employee pension (SEP) plans, also known as SEP/IRAs since they make use of individual retirement accounts, are pension plans intended specifically for self-employed persons and small businesses. Created by Congress and monitored by the Internal Revenue Service, Simplified Employee Pension plans are designed to give small business owners and their employees the same ability to set aside money for retirement as traditional large corporate pension funds. SEP plans are available to all types of business entities, including proprietorships, partnerships, and corporations.

As employer-funded retirement plans, SEPs allow small businesses to direct at least 3 percent and up to 15 percent of each employee's annual salary into tax-deferred IRAs on a discretionary basis up to a specified dollar amount, whichever is less. SEP plans are easy to set up and inexpensive to administer, as the employer simply makes contributions
to IRAs that are established by or on behalf of employees. The employees then take responsibility for making investment decisions regarding their own IRAs. Employers are able to avoid the risk and cost involved in accounting for employee retirement funds. In addition, employers have the flexibility to make large percentage contributions during good financial years, and to reduce contributions during hard times. Like other tax-deferred retirement plans, SEPs provide a tax break for employers and a valuable benefit for employees.

In many ways, SEPs can be more flexible and attractive than corporate pensions. They can even be used to supplement corporate pensions and 401(k) plans. Many people who are employed full-time use SEPs as a way to save and invest more money for retirement than they might normally be able to put away under IRS rules. In fact, an article in *Forbes* magazine called SEPs a "moonlighter's delight," in that they enable full-time employees to contribute a portion of their self-employment income from consulting or free-lancing outside of their regular jobs.

**Rules Governing SEPs**

The rules governing SEPs are fairly simple but are subject to frequent changes, so annual reviews of IRS publications 560 (retirement plans for the self-employed) and 590 (IRAs) are recommended. The SEP plans are easy to set up and do not require a separate trustee. The maximum allowable tax-deductible SEP contribution per employee is 15 percent of net compensation or a specified dollar amount, whichever is lower. Since the specified dollar amount is open to change, we have not listed it here. Our intent is for the agent to keep up with the changes, meaning he or she must yearly check to see what the dollar amount is. In general, eligibility is limited to employees 21 or more years old with at least three years of service with the company and a minimum level of compensation.

A similar program is the **Savings Incentive Match Plan for Employees (SIMPLE) IRA**. SIMPLE plans became available in January 1997 to businesses with less than 100 employees, replacing the discontinued Salary Reduction Simplified Employee Pension (SARSEP) plans. They are intended to provide an easy, low-cost way for small businesses and their employees to contribute jointly to tax-deferred retirement accounts. An IRA set up as a SIMPLE account requires the employer to match up to 3 percent of an employee's annual salary, with an upper dollar limit per year. Employees are also allowed to contribute to their own accounts, again subject to a maximum limit. In this way, a SIMPLE IRA is similar to a 401(k), but it is generally less complex and has fewer administrative requirements.

Companies that establish SIMPLEs are not allowed to offer any other type of retirement plan. The main problem with the plans, according to Stephen Blakely in *Nation's Business*, is that “Congress is already drafting legislation that would make SIMPLE less simple and more costly for the very businesses the plans were created to serve.”
SEP Advantages

- Contributions to a SEP are tax deductible and your business pays no taxes on the earnings on the investments.
- You are not locked into making contributions every year. In fact, you decide each year whether, and how much, to contribute to your employees’ SEP-IRAs.
- Generally, you do not have to file any documents with the government.
- Sole proprietors, partnerships, and corporations, including S corporations, can set up SEPs.
- You may be eligible for a tax credit of up to $500 per year for each of the first 3 years for the cost of starting the plan.
- Administrative costs are low.

SEP Terms

Employee: An “employee” is not only an employee, but can also be a self-employed person as well as an owner-employee who has earned income. In other words, an individual can contribute to a SEP-IRA on his or her own behalf. The term also includes employees of certain other businesses owned and certain leased employees.

Eligible Employee: An eligible employee is an employee who:

1. Is at least 21 years of age, and
2. Has performed service for the company in at least 3 of the last 5 years.

All eligible employees must participate in the plan, including part-time employees, seasonal employees, and employees who die or terminate employment during the year. The SEP may also cover the following employees, but there is no requirement to cover them:

1. Employees covered by a union contract;
2. Nonresident alien employees who did not earn income from you;
3. Employees who received less than a specified amount in compensation during the year (subject to cost-of-living adjustments).

Compensation: The term generally includes the pay an employee received from their employer for a year’s work. As either the owner or employee, compensation is the pay received from the company. Employers must follow the definition of compensation included in the plan document.
Establishing the Plan

There are just a few simple steps to establish a SEP.

Step 1:
Contact a retirement plan professional or a representative of a financial institution that offers retirement plans and choose the IRS model SEP, Form 5305-SEP, *Simplified Employee Pension – Individual Retirement Accounts Contribution Agreement*, or another plan document offered by the financial institution. Regardless of the SEP document chosen, when filled in, it will include the name of the employer, the requirements for employee participation, the signature of a responsible official, and a written allocation formula for the employer’s contribution.

A SEP may be established as late as the due date (including extensions) of the company’s income tax return for the year they want to establish the plan. For example, if the business’s fiscal year (a corporate entity) ends on December 31 and it filed for the automatic 6-month extension, the company’s tax return for the year ending December 31 of that tax year would be due on September 15 of the following year, allowing the employer to make the initial SEP contribution no later than September 15 of that same year.

**Example:** Fiscal year ending 2009 and filing the 6-month extension would have until September 15, 2010 to pay taxes and initiate a SEP plan.

Choosing a financial institution for the SEP is one of the most important decisions made, since that entity becomes a trustee to the plan. Trustees work closely with employers and agree to:

1. Receive and invest contributions, and
2. Provide each participant with a notice of employer contributions made each year and the value of his or her SEP-IRA at the end of the year.

Trustees of SEP-IRAs are generally banks, mutual funds, or insurance companies *that issue annuity contracts*, and certain other financial institutions that have been approved by the IRS.

Step 2:
Complete and sign Form 5305-SEP (or other plan document, if not using the IRS model form). When it is completed and signed, this form becomes the plan’s basic legal document, describing the employees’ rights and benefits. Do not send it to the IRS; instead, use it as a reference since it sets out the plan’s terms (e.g., eligible employees, compensation, and employer contributions).
Step 3:
Give the employees a copy of the Form 5305-SEP (or other plan document, if not using the IRS model form) and its instructions, along with certain information about SEP-IRAs (described in Employee Communications below). The model SEP is not considered adopted until each employee is provided with a written statement explaining that:

1. A SEP-IRA may provide different rates of return and contain different terms than other IRAs the employee may have;
2. The administrator of the SEP will provide a copy of any amendment within 30 days of the effective date, along with a written explanation of its effects; and
3. Participating employees will receive a written report of employer contributions made to SEP-IRAs by January 31 of the following year.

Operating the SEP Plan

Once in place, a SEP is simple to operate. The trustee will take care of depositing the contributions, investments, annual statements, and any required filings with the IRS.

SEP Contributions

The employer’s obligation is to forward contributions to the financial institution or trustee for participating employees. Employers must keep their financial institution aware of any changes in the status of participating employees. As new employees are hired, if they satisfy the eligibility criteria described in the plan, then the employer would notify their financial institution of the addition to participating employee rolls.

Contributions to each employee’s SEP-IRA account cannot exceed the lesser of that year’s specified dollar amount or a percentage of the employee’s compensation. These limits apply to the total contributions to the plan and any other defined contribution plans (other SEPs, 401(k), 403(b), profit-sharing, or money purchase plan) the company has.

Employers are not required, as we previously said, to make contributions every year. When employees contribute, they must contribute to the SEP-IRAs of all participants who actually performed work for the business during the year for which the contributions are made, even employees who died or terminated employment before the contributions were made (as long as they met plan participation criteria). Contributions must be uniform for all eligible employees.

Employee salary reduction contributions cannot be made under a SEP.

There are special rules for those who are self-employed. For more information on the deduction limitations for self-employed individuals, see IRS Publication 560, Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).
Employee Communications

When employees participate in a SEP, they must receive certain key disclosure documents from either their employer or the financial institution acting as trustee:

1. Employees must receive a copy of IRS Form 5305-SEP and its instructions (or other document used to establish the plan). New employees who become eligible to participate in the plan must also receive a copy of the plan.

2. Provide employees a written statement containing information about the terms of the SEP, how changes are made to the plan, and when employees are to receive information about contributions to their accounts.

3. The financial institution must provide each employee participating in the plan with a plain, non-technical overview of how their SEP operates.

In addition to the information above, the financial institution provides an annual statement for each participant’s SEP-IRA, reporting the fair market value of that account. The financial institution also gives participating employees a copy of the annual statement filed with the IRS containing contribution and fair market value information.

When employees participating in the plan receive distributions from his or her account, the financial institution sends them a copy of the form that is filed with the IRS for the individual’s distribution. The financial institution will notify the participant by January 31 of each year when a minimum distribution is required.

Reporting to the Government

SEPs are generally not required to file annual financial reports with the Federal government. SEP-IRA contributions are not included on the Form W-2, Wage and Tax Statement. The financial institution or trustee handling employees’ SEP-IRAs provides the IRS and participating employees with an annual statement containing contribution and fair market value information on Form 5498, IRA Contribution Information.

The financial institution will also report on Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., any distributions it makes from participating employees’ accounts. The 1099-R is sent to those receiving distributions and to the IRS.

Distributions

Participants cannot take loans from their SEP-IRA. However, participants can make withdrawals at any time. These monies can be rolled over tax free to another SEP-IRA, to another traditional IRA, or to another employer’s qualified retirement plan (provided the other plan allows rollovers).
Money withdrawn from a SEP-IRA (and not rolled over to another plan) is subject to income tax for the year in which an employee receives a distribution. If an employee withdraws money from a SEP-IRA before age 59½, a 10 percent additional tax generally applies.

As with other traditional IRAs, participants in a SEP-IRA must begin withdrawing a specific minimum amount from their accounts by April 1 of the year following the year the participant reaches age 70½. For the year following the year in which a participant reaches age 70½, he or she must withdraw an additional required minimum distribution amount by December 31 of that year, and annually thereafter. The financial institution/trustee will notify the participant by January 31 of each year when a minimum distribution is required.

**Monitoring the Trustee**

As the plan sponsor, the business should monitor the financial institution or trustee to be sure it is doing everything required. The business should also ensure that the trustee’s fees are reasonable for the services being provided. If the trustee is not doing its job properly, or if its fees are not reasonable, the business might want to consider replacing the trustee.

**Terminating the Plan**

Although SEPs are established with the intention of continuing indefinitely, the time may come when a SEP no longer suits the purposes of the business. To terminate a SEP, the financial institution must be notified that contributions will cease for the next year and that the business wants to terminate the contract or agreement. Although not mandatory, it is a good idea to notify the employees that the plan is being discontinued. It is not necessary to notify the IRS that the SEP plan has been terminated.

**Correcting Errors**

Even with the best of intentions, mistakes in plan operations happen. The U.S. Department of Labor and the IRS have correction programs to help employers with SEPs correct plan errors, protect participants’ interests, and keep the plan’s tax benefits. These programs are structured to encourage early error correction. Ongoing review makes it easier to spot and fix mistakes in the plan’s operations.

**Owners Benefit Less Than Non-Owner Employees**

A note of caution is in order. A small business owner who wants to establish a SEP or any other qualified retirement plan for him or herself must also include all other company employees who meet minimum participation standards. As an employer, the small business owner can establish retirement plans like any other business. As an employee,
the small business owner can then make contributions to the plan he or she has established in order to set aside tax-deferred funds for retirement, like any other employee. The difference is that a small business owner must include all non-owner employees in any company-sponsored retirement plans and make equivalent contributions to their accounts. Unfortunately, this requirement has the effect of reducing the allowable contributions that the owner of a proprietorship or partnership can make on his or her own behalf.

For self-employed individuals, contributions to a retirement plan are based upon the net earnings of their business. The net earnings consist of the company's gross income less deductions for business expenses, salaries paid to non-owner employees, the employer's 50 percent of the Social Security tax, and the employer's contribution to retirement plans on behalf of the company's employees. Therefore, rather than receiving pre-tax contributions to the retirement account as a percentage of gross salary, like non-owner employees, the small business owner receives contributions as a smaller percentage of net earnings. Employing other people thus detracts from the owner's ability to build up a sizeable before-tax retirement account of his or her own. In the case of a SEP plan, the business owner's maximum annual contribution is reduced to 13.04 percent of income (compared to the 15 percent maximum that applies to non-owner employees), to a specific dollar maximum.

Even so, a SEP plan offers significant advantages for self-employed persons and small business owners. It allows a much greater annual pre-tax contribution than a standard IRA. In addition, individuals can contribute to their existing IRAs and 401(k)s, and still participate in their SEP plan.

**Divorce and Retirement Accounts**

At one time the house was the biggest asset to split in most divorces. Today it may well be the retirement account. Whether it is a pension or profit-sharing arrangement, 401(k), IRA, stock bonus plan or Keogh, it will probably be split up as part of the divorce property settlement. While agents seldom want to find themselves in the middle of a divorce it may well happen if it happens to be an annuity or some other vehicle funded through an insurance company the agent represented.

**Retirement Plans at Work**

Retirement accounts are often divided by using a qualified domestic relations order or QDRO. A QDRO is specific language that needs to be included in the divorce papers.

The QDRO establishes the soon-to-be-ex-spouse's legal right to receive a designated percentage of the qualified plan account balance or benefit payments. Since the divorcing spouse may be entitled to this money, he or she will also be responsible for
paying the related income taxes when that money is received in the form of a pension, annuity, or withdrawals. In effect, the ex-spouse becomes a co-beneficiary of the existing qualified plan account.

Alternatively, the QDRO arrangement permits the ex-spouse to withdraw his or her share and roll the money over into his or her own IRA (to the extent current withdrawals are permitted by the terms of the qualified retirement plan). The IRA rollover procedure allows the ex-spouse to take over management of the money as well while continuing to postpone taxes until funds are withdrawn from the IRA. The important point from the earning spouse’s perspective is that his or her ex will be the one who owes any taxes due.

While we often prefer to avoid legal documents out of fear or lack of understanding, it is not wise to split pensions without having a QDRO. Without such legal documents, the pension-earning spouse would have a taxable distribution and resulting taxes and penalties. In other words, he or she would owe the IRS for money that actually went to the ex-spouse. It would be a tax-free windfall for the ex-spouse at the expense of the earning spouse. It might also include a 10% premature withdrawal penalty if the account-holder is under age 59½. Agents should never act as legal counsel but the agent may well want to advise both clients (husband and wife) to seek legal help before splitting any account designed for retirement income.

Understanding why a QDRO is advisable is the first step. The next is to set one up. To do so, the language in the divorce papers must include the following:

- The name and mailing address of the "plan participant" and the "alternate payee";
- Each retirement qualified plan account to be split up under the divorce;
- The dollar amount or percentage of benefits to be paid from each account to the alternate payee; and
- The number of payments or benefits period covered by the QDRO.

To be safe, the papers should also specify that a qualified domestic relations order is being established under their state's domestic relations laws and Section 414(p) of the Internal Revenue Code.

There are a few other procedural details, so a tax professional with substantial divorce case experience should be consulted to make sure the process goes smoothly. This must happen before the divorce papers are finalized. Do not assume the divorce attorney knows how to properly draft a QDRO. Many attorneys do not understand the tax implications of splitting a pension plan. Again, we are not advising agents provide either tax or legal advice. Doing so is foolish, but it may be wise to suggest to the divorcing clients that each seek out a pension specialist regarding this prior to finalizing their divorce.
If the qualified pension plan is with a major company, the plan administrator will usually make sure the divorce papers include proper QDRO language before allowing the divorcing individuals to withdraw any money but this cannot be taken for granted.

The risk is highest that the pension administration will not require a proper QDRO when it is a small business or the earning spouse manages the qualified retirement plan personally, without the help of a qualified administration. This often happens when the pension earner is self-employed, such as agents tend to be. People in this position often hand over qualified retirement account money without a QDRO because they do not understand the tax implications and the potential penalties involved.

IRAs and SEPs

A QDRO is not required to split up an IRA account, but the pension earner still needs to be very careful. It is possible to roll over money tax-free from one IRA or SEP to another without it being considered a withdrawal under certain circumstances, but when an ownership change is involved taxation and penalty rules could apply. It should only be done if this division is called for in the divorce property settlement. Then the pension earner does not have some of the responsibility he or she might otherwise have.

At all times the focus should be on avoiding tax implications and penalties that could be involved in splitting a pension fund, regardless of the type it happens to be. Usually the divorce papers need to include the following wordage: "Any division of property accomplished or facilitated by any transfer of IRA or SEP account funds from one spouse or ex-spouse to the other is deemed to be made pursuant to this divorce settlement and is intended to be tax-free under Section 408(d)(6) of the Internal Revenue Code." It may not say this word-for-word but some form of it should exist.

If money from an IRA account set up in one person’s name and is transferred to the other spouse without proper documentation and use of correct legal avenues the earning spouse may find him or herself paying taxes and penalties that would not otherwise have been due. The same rules apply to simplified employee pension (SEP) accounts, because they are treated as IRAs for this purpose.

How do people most commonly get into trouble? Some try to make predivorce rollovers from one spouse's IRA to the other's thinking it is a tax-free transaction. It often is not. It could be treated as a taxable distribution to the IRA owner (the person in whose name the account is set up). Others try to satisfy post-divorce financial obligations to their ex by taking IRA withdrawals. Once again, this will always trigger an immediate tax bill for the IRA owner, even though the ex-spouse receives the money.
Women are Receiving More These Days

There was a time when pension funds were not divorce issues. The person earning the pension kept it; this usually meant the husband had the pension and the wife did not. That is no longer true. Many divorces now involve pension divisions. The earning spouse is most likely to lose half, but sometimes he or she loses the entire account if other conditions warrant it. It is now common to hear: “She/He took my retirement. I didn't even think that was a possibility.”

Men have always complained about their divorce settlements, but in reality, they've typically come out far ahead financially. Women often ended up living in poverty circumstances, even when alimony was granted. No longer. Today’s divorcing women are closer than ever to achieving parity. Due to many factors, courts are putting a higher price tag on what the nonworking or lower-earning spouse, usually the wife, contributes to the marriage. Judges are granting more alimony, putting more assets in play, and increasingly requiring husbands to pay their wives' legal fees. Of course, each case is individual, but primarily pensions are now on the divorcing tables.

Keep Premarital Assets Separate

Although most people fail to do this, marrying couples should keep their premarital assets separate even during marriage. Any money one spouse brings into a marriage before the wedding is considered separate property should the couple get divorced. There is one important exception to the rule: commingling funds in a joint bank account or spending it on something for the couple changes it to joint property in most cases.

Protect Your Inheritance

In most states an inheritance, regardless of when it was received, is also viewed as separate property, unless it is gifted to the spouse. Again, if the money is deposited into a joint account or spent on something for the couple, then the assets are converted into marital property.

After the Divorce

Faced with the financial responsibilities of being single again, many recently divorced people put retirement savings on hold, but that is a big mistake. Instead, they should reorganize their financial priorities to find a way to continue saving for retirement. The time will still come and retirement funding will still be a necessity. In fact it may be even more important to save for retirement since the individual will be relying on one income rather than two.

A divorce could also leave the person with investments that do not fit his or her investment goals. Perhaps they involve more risk than the individual is comfortable with
or maybe they are too conservative for the time frame involved until retirement. The divorced individual may need to reassess what they already have for retirement as well as set future goals for acquiring more retirement assets.

A divorced individual may be able to collect Social Security based on their ex-spouse's entire earnings history, even earnings earned after the divorce. This is known as "derivative benefits." It is particularly attractive for stay-at-home parents who have had little earned income of their own. There are, however, certain restrictions: the marriage must have lasted at least 10 years, and the individual cannot have remarried at the time he or she starts collecting benefits.

Derivative benefits equal half of the ex-spouse's own benefit. In other words, if the ex-spouse receives $1,000 per month, the ex-spouse would receive $500. Individuals need to choose between collecting their own Social Security or the derivative benefit, whichever is more. It is not possible to collect both the ex-spouse's and their own simultaneously. Details are available at the Social Security Administration's website.

**Dividing Other Investments**

While attorneys may be very knowledgeable on the divorce laws of their state, they may not necessarily be as well versed on taxation, financial vehicles, pensions and other financial issues. The 50/50 split they proposed in court might actually be a 60/40 split after taxes are taken into account. Again, insurance agents should never offer legal advice, but they should suggest a tax accountant or financial expert be consulted. This would especially be true if their clients are asking questions about the vehicles they purchased from the agent in a divorce context.

While still married, generally people can make unlimited tax-free transfers of investment assets held in taxable accounts or anywhere else. The same is true for later transfers between the divorcing couple if they are made per the divorce property settlement. This assumes both spouses are U.S. citizens. After such a tax-free transfer, the new owner's tax basis in the investment is the same as the old owner's, and the new owner's holding period includes that of the old owner. Nothing should ever be assumed, however. All transfers should be done after consulting with a tax and investment specialist since many taxation factors are affected by divorce.

For example, if the property settlement calls for one party to give the other some long-held stock, there is no immediate tax impact. The ex-spouse steps into her husband’s shoes and keeps going under the same tax rules that would apply if he still owned the stock. If the stock was jointly owned or community property, nothing changes tax wise. When your ex-spouse sells, she will owe the federal capital gains tax plus any state and local taxes.
Of course, that's the tax catch. When she ends up owning appreciated investments, they come with a tax liability attached. The bigger the gain, the bigger the built-in tax bill. So from a net-of-tax point of view, appreciated investments are worth less than an equal amount of cash or financial items that have not appreciated.

**Good News for Attorneys**

Almost half of all marriages in the U.S. end in divorce, according to the National Center for Health Statistics. On average the couple's divorce proceedings will have cost between $20,000 and $30,000 in legal fees alone, according to Alan Feigenbaum, a certified financial planner and author. Divorce is second only to death in “traumatic” experiences.

Due to the high costs (often more than either party can afford) many are turning to mediators and this can prevent some financial mistakes with pensions as well. Of course, the mediator must be versed in such issues, so both parties should ask for the individual’s qualifications prior to employing them.

However the couple separates their financial vehicles, the separation can be financially painful since one party is giving up something of value to the other. Many financial planners, due to our high divorce rates, now recommend that even happily married couples have separate pensions from the start of their marriage. While one person’s pension may be tied to an employer it does not mean that both have to be. Putting an equal amount into an annuity or some other format can provide equalization. Of course, we all want to believe that our marriages will last; if that proves true it just means there will be two accounts funding the couple’s retirement. It never hurts to have more money in retirement than might otherwise have existed.
Sensible Ethics

What Ethical Agents Know

Selling insurance is not for the weak-minded, but it can be very enjoyable with the right outlook. Hello, my name is Harry Bobs and I will be your “ethical” narrator for this course. I have been in the insurance field longer than you may have lived. I’ve seen it all: agents who lie, cheat, and steal. I have also seen agents who truly care about their clients, becoming lasting friends with many of them. The latter is certainly more enjoyable for both parties. I do not believe most agents are unethical; on the contrary, my experience tells me the opposite is true. Unfortunately, we ethical agents jump through many legal hoops due to the few unethical among us.

Each state has an insurance department whose job is to look out for their state’s citizens. This is not an easy task. The “he-said-she-said” scenario is often what they have to work with; not hard proof. As a result, their only avenue is often consumer legislation. Such legislation, while often necessary, means that the ethical agent must jump through numerous hoops. Typically the unethical agent is only selling insurance for a short time, but he leaves behind financial damage that must be straightened out by the ethical agent that follows. If the damage is never straightened out the consumer may find themselves in a financially devastating position at some point – often at retirement age.

Insurance is necessary. It protects property, people and futures from financial ruin. In many areas, it would be impossible to open a new business if insurance were not available because the banks that loan the money wouldn’t loan to them without insurance protection in place. Banks would not loan money for a new car if the buyer did not also purchase insurance to protect the bank’s investment. Without insurance, home loans would not be possible in most cases. Without insurance, families would face years of poverty because the major breadwinner died prematurely. Those who sell insurance need to realize the important position they hold and be proud of the industry they represent. Realizing the importance of insurance is only the first step, of course. From there the field agent must gain the knowledge and communication skills necessary to perform not just an adequate job, but a professional job. The financial futures of their clients are often in the agent’s hands.
Insurance Perceptions

If you tell a man that he has a one in five chance of entering the nursing home (and you are selling nursing home policies) he will tell you that means he has a greater chance of never needing to go there – and he’d be right.

Tell that same man that he has a one in five chance of winning his state’s lottery and he will be in his car heading to the nearest store to buy lottery tickets before you can even finish your sentence.

It is all a matter of perspective: we will rationalize our reasons to buy what we want as well as why we don’t need to buy something as mundane as insurance. In this case, he had no desire to enter a nursing home but he wanted to win the lottery. He will not spend his money on a nursing home premium but he will spend it on lottery tickets – even though our example gave the exact same odds in both cases.

Of course, we know that the odds of winning the lottery are more like a million to one than five to one, yet people buy lottery tickets every day. Insurance is a non-tangible. It cannot be driven down the road, washed proudly every Sunday, or shown off to the guy next door. Furthermore, your friends are not interested in looking at your policy but they will study the engine in your new car. Let’s face it: buying something tangible is just more fun than buying insurance.

Most Americans are poor savers. The declining stock market has actually boosted the percentage of savings we make, but it still is not enough for the many years we will spend in retirement.

Behavioral economists (researchers who mix psychology and economics) have found three reasons why people seem to find it so difficult to save:

1. **Temptation**: No one is surprised at this. People are bombarded by television ads on everything from tennis shoes to automobiles. Even credit is dangled in front of us in the form of advertising through the mail – actually sending out the unsolicited credit cards in many cases. Even the grocery store offers temptations with candy within easy view and snack cakes practically following us every step of the way.

2. **Lack of Understanding**: Many Americans simply do not understand the concept and rewards of saving money. Our grade school children no longer have class saving accounts. When I was young every student opened a savings account with a few dollars and saved change for a monthly deposit. We all marched to the local bank and made our deposits on a specific Friday each month. We were all very proud of our growing sums. Today the banks will not open such accounts because there is too little in them to make it profitable. Schools do not want to put added stress on poor families that cannot spare even the few dollars it would
require. Somewhere along the line grade school classes entirely quit teaching the idea of saving.

3. Finally, **Optimism**: Americans are famously optimistic. Someone will support us as we age. Or maybe we will inherit a million dollars or maybe win the lottery. Something will work out. Maybe it will be the government who gives us the solution (it’s hard to believe anyone has that kind of government faith!), the Veteran’s Association will house us and feed us (yeah, right!), or our children and grandchildren will lovingly take care of us in our retirement. Someone will support those who don’t save.

Someone may well be forced to support those who did not save for retirement – the taxpayers, which equates into our children and grandchildren and all the other people who work each day trying to raise their own children and pay their own mortgages. The support received through those taxpayers will not be adequate however. There won’t be much traveling; there may not even be adequate money for medical needs. The non-savers will merely survive.

There is good news. Researchers have found that merely visualizing a purchase brings the same “feel good” response as actually making the purchase. They also found that visualizing saving for a future reward brought about the same chemical “feel good” response in the human brain. So maybe having a secure retirement is more a matter of training people to focus on the goal: with retirement activities like golfing or travel as the bait.

The fact that, like saving for retirement, buying insurance is seldom considered recreational means agents must be masters of the product and excellent communicators in the field. There is no room for sissies.

**Establishing Goals**

Everyone needs to have a goal, even insurance agents. In this case, I am referring to an ethical goal. I know from experience that ethical agents are just as successful as the unethical agent is – over time, more so. Ethical agents build a sound foundation for their business through moral standards. Just as a building needs a sound foundation to withstand the elements, agents need a sound foundation to withstand the ups and downs of the insurance markets. Those who built their business on a sound moral foundation will have clients that refer them to their friends so even the “down” times in the market do not adversely affect them.

At one time there was a billboard in Houston, Texas that asked: “*Whatever happened to personal responsibility?*”
The answer is simple: each of us still has responsibility – even those who refuse to acknowledge it. Refusing to accept personal responsibility does not mean it goes away. Parents are still responsible to raise their children with love, government is still responsible to those who hired them (our citizens and taxpayers), and insurance agents are still responsible to their clients and insurers. *Refusing to act responsibly does not remove the requirement.*

As an agent you are responsible to treat your clients fairly, to provide the services they deserve, and to fulfill other professional responsibilities. Isn’t that why you are completing this course? Like many agents, you are doing this course because it is your professional responsibility to do so. Even without such requirements, however, professional agents would still read product brochures, news articles, and industry magazines, striving to learn more about their chosen industry. That’s what personal responsibility is all about: accepting and doing what we are responsible for. Our mamas are not responsible for what we do or fail to do; our boss is not responsible; our spouse is not responsible. Each of us has a duty to complete what is necessary for our profession and our personal lives, whether it happens to be completing our continuing education in a timely manner or mowing the lawn before it gets knee high.

All of us know someone who, in their own mind, is never to blame for anything. It is his manager’s fault that his leads aren’t good; it is his accountant’s fault that he failed to pay his taxes; it is his wife’s fault that his bills aren’t paid. We expect this attitude from our teenager who has not yet matured, but it is frustrating to see an adult refuse to accept personal responsibility. Whether it is failure to comply with state education requirements in a timely manner, failing to refund a premium within time requirements, or simply placing an inadequate policy, some people just never seem to accept their own responsibility for life’s mistakes and shortcomings. The responsible agents accept their mistakes and strive to correct them, and then learn from the error so it is not repeated. Mistakes become learning tools.

When I was a green agent I mistakenly told a new client that her policy would cover something it did not. When I realized my mistake I returned in person (totally embarrassed) to tell her of my error. I expected her to cancel the application immediately. Being a lady of quality she accepted my apology but also kept the policy. As she explained it: “I can probably get any policy I need from any agent, but it is not possible to get integrity with any agent.” She remained my client until her death some years ago.

Responsibility is really just another word for *accountability* – especially in our industry. It is easy to profess accountability when no mistake has been made. The truly ethical agent demonstrates accountability, however, when fault must be accepted. It is not just given lip service. Like my experience, an error may even have unexpected results.
I personally believe that “accountability” is a trickle down effect. If the company owner or manager is accountable, his or her employees are much more likely to be as well. Sit in any diner in America and you can quickly tell the mentality of the staff. Does the waitress take care of everyone, even when the table is not in her service area? Will the hostess help clear a table so their customers are seated quickly? Is the manager willing to pick up the pot of coffee and fill cups to help out his staff? Everyone has seen examples of outstanding service and attitude and everyone has also seen the complete opposite – employees waiting for someone else to take responsibility.

Whoever the leader is, his or her actions and accountability will be taken up by those who follow. Agents often work alone so they must be accountable on a personal basis, but there are still actions that follow their lead. The accountable agent returns telephone calls as soon as practical, they follow up problems to see if they were solved, and they demonstrate they are interested in their client’s financial well-being.

Who would be the followers in this case? Everyone the agent comes in contact with in his business day. That includes his customers who will either brag on their agent or complain to others when the agent has not been accountable.

It is partly attitude, of course. The person who likes his job will automatically want to do a good job but that doesn’t mean it is always easy to stay accountable. After a long day it would be easier to ignore the telephone messages that wait for us, for example. It takes a mental discipline to stay focused on our accountability – tired or not.

Since we must also be accountable to our families where is the line drawn between work and home? Being professionally accountable does not mean clients must absorb every waking hour. Many agents have set times for returning messages, following up on claims, and the countless other tasks that take up our time as agents. Perhaps it is between four and five each afternoon; perhaps it is every Monday and Wednesday morning – whatever time frame is used, the agent does follow up ensuring his clients are taken care of. As long as clients know the time table, it goes smoothly. In short, the agent is accountable.

Regardless of the situation, our choices are our own. Yes, sometimes the right choice is the difficult choice; it could even cost us our job in some situations. However, for most of us making the right choice will not affect our job, except perhaps to make it better. Being accountable does not mean our life is more difficult; in fact, it usually makes it easier. For example, it is easier to mow the lawn before it grows knee high. It is easier to complete required education before the last week it is due. Being accountable makes our lives easier more often than not. Besides being accountable for the choices we make, we have the freedom to make better choices, like saving for retirement or returning that client’s call (which turns out to be a referral). Those who refuse to accept personal accountability often make their lives harder than it needs to be.
For example:

Andrew Agent failed to complete his continuing education earlier in the year. Now it is due in ten days. He has a several choices:

1. He could blame his manager or office receptionist for not reminding him it was due soon. He might say to himself: “What is wrong with this company? They know when I am due. What would it have taken for someone to simply mention it a couple of months ago?”

2. He could look toward his secretary if he works independently. He might say to her: “I pay you to take care of this office; that means reminding me of important matters like this.”

3. He could call the education company he previously used and ask them why they didn’t’ send an email. He might say: “I listed my license renewal date. Why didn’t you email me a reminder? You may have cost me state late fees.”

4. He could call the education company he previously used and ask for recommendations. He might say to them: “I really goofed this year. Time got away from me and I am due in ten days. What do you recommend I do to speed this along?”

While it may well be a chore of office staff to follow agent license renewal dates, it is the agent’s responsibility to know not only when his or her license renewal takes place, but also what is required to renew that license. This includes keeping a list of previously completed CE courses, with the course ID number listed. This prevents an agent from duplicating a course that might then be refused by the state when renewing his or her insurance license. In any profession that requires a state license of some type, it is the individual’s responsibility to do what is expected to allow a smooth license renewal. Even when another person normally reminds the agent of a pending need for continuing education, professionals always track their own requirements.

Andrew Agent may work for a company that will take on all his responsibility, but ultimately he is an adult, with adult accountability. The continuing education company is not responsible to remind him of a coming license renewal or even the renewal requirements of his state. Most companies will make recommendations if asked. Accountability nearly always makes our lives easier because others are more likely to extend a helping hand.

Why Be Ethical?

In the long run, it pays financially as well as personally to be ethical. Those who plan to have a career as an insurance agent will do better financially if they are ethical. The unethical individual may do better financially for a short period of time, but for those
who consider this their career it is vital to be viewed as ethical. When clients realize their 
agent cares about them and their financial welfare they will refer their agent to their 
friends. There is no better way to keep business and grow than through referrals.

Of course another very important reason to be ethical is a no-brainer: it is the law. Agents must follow their state and federal guidelines. The majority of insurance law 
concerns consumer protection, not protection of field agents. You’re on your own baby!

For myself, being ethical is just as important as showing my father that I am successful 
in my career choice. It is a matter of pride. My actions are a reflection of who I am as a 
son, father, and grandfather; I want to be proud of the choices I have made. I want my 
family to be proud of who I am. Each person will have their individual reasons for their 
own code of ethics. You cannot sit on the fence when it comes to ethical behavior; you 
either are or are not ethical – there’s no in-between on this. Your actions will also define 
who you are to your friends (and whether they will recommend you to their friends), but 
they are seldom the important people in your life unless you have no family members. It 
is our family that truly counts in our lives. *We show off for our friends, but we live for 
our family.*

Our families know who we really are; our friends just think they know us. Your wife 
knows you lay around Sunday morning in your boxers; you want your friends to believe 
something else. Your children know when you are cranky (and they know when to avoid 
you); your friends only see the cheerful side you present. You can’t fool your family; 
they see who you really are. Your spouse may support or oppose you on your ethical 
issues but she knows what you really think better than your friends or colleagues do. 
Your children may not say what they think but they do observe you. It is likely they will 
become the same type of adult they see in you. Whatever you tell your children will be 
totally overshadowed by what you demonstrate with your behavior. When you lay in 
your grave at the end of your life, your friends will all slap each other on the back and 
proclaim what a great guy you were. Your family will know the truth of your life; your 
family will remember the truth you demonstrated behind closed doors. It is this truth that 
actually lives on when your life ends, not what your friends thought they knew.

Does this seem a bit too dramatic when all we are talking about is selling insurance? I 
guess it is a matter of perspective; my actions matter to me all the time, even when I sell 
insurance.

**Following the Law**

From a purely practical standpoint, each agent must know and follow their state’s 
insurance law. If any federal laws exist, of course that must also be followed. The 
insurance companies an agent writes for will monitor such requirements; the forms will 
be correct for the issuing state, the manner in which new business is submitted will be
molded to the appropriate laws, and the insurer will notify agents if they fail to follow the applicable requirements. Of course, the insurer cannot monitor an agent’s every move. They don’t know if you represented the products correctly; whether you obtained all the required signatures or how you treated the applicants. They must be able to trust their field force to some degree. They must assume their field force will represent their products fairly and comply with state and federal laws regarding the products they sell.

Many states are implementing specific educational requirements in an attempt to dispel the old “I didn’t know” response when caught disobeying the law. Laws are also beginning to place more responsibility on the insurers, requiring them to monitor the agent’s acquired education in specific fields, such as federal Partnership LTC policies and anti-money laundering. Specifically, the Deficit Reduction Act of 2005 opened up asset protection nursing home policies to all states; insurers marketing these products must be able to prove their agents acquired the proper education prior to selling them. Most states already have or will adopt the NAIC Partnership format, meaning as long as the acquired education was based on the NAIC guidelines it satisfies the federal requirements. Therefore, an agent taking the NAIC Partnership format in any state that has adopted that education format may use it to meet the requirements in any other NAIC Partnership state. The insurers have the responsibility of verifying the education was appropriately completed. This becomes increasingly easier as all the states eventually become uniform in the continuing education courses they approve. In a few states, the Partnership nursing home continuing education must be acquired only in classroom formats, so insurers may have an easier time of monitoring agent education in those states.

Ethics in the Workplace

Regardless of our occupation, each of us faces ethical issues every day. When any given profession deals with a commission base, this seems to be especially true. Ethics could be talked to death and frankly, talk is not worth much. It is actions that really tell the true story. The bottom line, however, is fairly simple when it concerns industry ethics: what is right and what is wrong?

Consider the definition of ethics:

eth'ics (eth'iks) n. pl. (1) the principles of honor and morality. (2) accepted rules of conduct. (3) the moral principles of an individual. - eth'ic, adj. pertinent to morals.

The New American Webster Dictionary

Ethics: the principles of honor and morality. That seems like a fairly simple statement, but what does it mean to an insurance agent? Who determines what is or is not ethical behavior? Must religious beliefs be a part of ethical behavior? Is it possible to make
your living in commission sales and still be ethical? Perhaps more to the point, is it possible to make a good living in commission sales and still be ethical?

While the study of ethics is actually a complex matter with many shades of right and wrong, basically ethics is about the meaning of life. It is the abstract view of what is right and wrong. There are few absolutes and many varied definitions. Even those who make their lifework the study of ethical behavior often do not come up with the same conclusions.

The purpose of this course is not necessarily to give any answers to the ethical questions. Rather, it is our intent to promote thinking. A thinking individual is a powerful person. The point of this course is to promote ethical thinking. It is our desire to provide a few "tools" of logic. Accepting personal accountability is actually empowering because it recognizes our ability to improve on the decisions we make. Maybe we have not saved to this point for retirement, for instance, but accountability recognizes our ability to change that and begin saving for our future. This change may mean we stop foolish spending in order to begin saving; certainly an empowering move.

The Same by Any Name

Ethics may sometimes be referred to as values. It may also be referred to as morality. It really does not matter what label we give it because the term is merely a word. What matters is how we make our decisions, how we respond to others, and how we view ourselves and our lives. Regardless of whether our ethics are stated or implied, they are always present. The decisions that are made, with or without ethical considerations, have profound effects on our own lives and those of others.

Businesses do, of course, base many of their decisions on financial aspects: What will bring a profit? How can costs be cut? How can taxation be minimized? There are always many aspects to a business and we often assume that a business is neither moral nor immoral. After all, the goal is profits. However, companies do have a moral or ethical responsibility to the community, its employees, and even to itself. Many companies have demonstrated that it can make large profits while performing ethically.

A background of ethics or values form the foundation of the decisions made. A company trying to minimize taxation may not think they are considering ethical issues, but ethics will be part of the final conclusion. If the company faithfully follows all lawful procedures while minimizing taxes that is an ethical decision. If the company makes misrepresentations to minimize tax payments, that is also an ethical decision. It just isn’t labeled as such by the company.

Because values become an integrated part of both personal lives and business conduct, individuals are often unaware that decisions are made with an ethical context. A person
who has formed an ethical core in early life will continue to make the majority of their decisions based on that early training (even if they are unaware of it).

For example, a salesperson that formed their early sales presentation on the basis of honesty and ethical conduct will, over the months and years, make a habit of saying their presentation in a certain manner. Court cases have been won and lost on this concept of "repeat actions." As time goes by, this sales presentation becomes a "habit" with little variation. Eventually, the salesperson may well forget how the original presentation was formed, but if ethics played a part in the original presentation, ethics will continue to play a part as time passes.

The same may be said of driving a car, riding a bicycle, and other daily habits that were initially "learned behavior" but become "reflex behavior."

Ethics began as society's code of unwritten rules. From the time humans began living together, such codes of unwritten rules were necessary simply to survive. Survival could not continue if the strong (typically males) took everything, including food and shelter, from those who were weaker. The weaker individuals were likely to be women and children. If women and children did not survive, the species could not have survived either. These rules established the way in which others were to be treated for the benefit of all.

For centuries, societies have argued over what is ethical or moral. It was during the fifth century B.C. in Greece that the philosopher Socrates gave ethics its formal beginning. The word ethics comes from the Greek word ethos, which means "character."

Each country will have ethics that are unique to its people and ethics that are common everywhere. In America, we have many variances in what is believed to be ethical because we have a varied population with a varied background. Our laws require each individual to conform to the laws of our country, even if they differ from the country of origin.

Other ethical values have been brought in by immigrants, both in the early days and continuing into today. One that is commonly thought of (and which many Americans now take for granted) is education. We often forget that obtaining education is, in fact, an ethical standpoint. It is not always easy to become educated. Like so many values or ethics, it requires concentration and hard work. Immigrants who come from lands where education is given only to select groups find our open education system a wonderful opportunity. Often immigrants take greater advantage of education than do established Americans. When opportunity is widely available, it is easy to forget its importance.

Early Americans considered religious freedom highly important. Since values are often defined as a criteria upon which important choices are made, religious freedom must be considered a value or ethical consideration. Many early immigrants came to America,
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despite the harsh circumstances of the New World, looking for religious freedom. The men and women who settled along the Eastern coasts came from Europe and brought with them their religion of choice: Christianity. Of these people, the Puritans probably had the greatest influence on early American values and ideology. To the Puritans, work was their most effective means of giving glory to God, so the work ethic had a strong effect on their lives. It was this early Puritan ideology which strengthened the importance of working hard. The Puritan businessman fully integrated his particular line of work with his religion.

Putting the Past into the Future

Every individual is a product of their past. In some way, each of us has been affected by the past. Even when society changes rapidly, current attitudes are formed from past experience. Whether how we live today is a reflection of what we enjoyed or liked in the past or a rejection of what occurred in the past, we are still affected by it. Perhaps it is impossible to understand current ethical considerations without having some understanding of the past and how it brought us to this point.

Our values, our thinking, and our actions are often directly related to the availability of education in America. Societies that wish to restrict the freedoms of others nearly always limit their access to education. The individual who does not have the ability to learn is less likely to understand human rights and resist oppression.

Higher levels of education naturally lend themselves to questioning. It is probably this questioning that has brought about much of the beneficial change in America. If certain groups had not questioned the use of child labor in factories, women’s right to cast a political vote, or a minority’s right to education in any school building, change would never occur.

Ethics may not be what we think brought about wide social change, but it always plays a role. While education involves the questioning of why certain things are done or thought, that education often has a moral edge to it. Child labor was used because it was cheap. That meant that the products they produced were less expensive to buy. It was not just education that prompted many to view the cheap labor as wrong; it was the moral view that children should not be economically exploited. Ironically the factories countered with the suggestion that allowing children to work helped their families economically. They gave little value to the quality of the children’s lives in those factories.

In the sixties, two major movements swept America: civil rights and antiwar sentiments. Though primarily led by our youth, the movements were backed by the majority of our mainline churches and other organized groups.
Who can forget the images we saw of Martin Luther King, groups of protesters, and the numerous conflicting views brought into our lives. For many people, this meant a new look at what we must perceive as right and wrong.

Although the seventies saw an almost immediate decline in the revolution for change that does not mean that we have been unaware of what is around us. Every day we are faced with starvation in many countries (some of it even in our own), energy problems, conflicts over environmental issues (jobs versus nature), inflation, run-a-way government spending and waste, high crime and drug problems, plus many more issues that affect our lives on a daily basis.

Much of the issues that America and her citizens have wrestled with are basically related to one issue: what is the right thing to do? This simple question often has multiple answers. This simple question often involves the decisions made by business.

As insurance representatives, we do not have the answers to the big problems, but we are often a mirror of what is going on in our neighborhoods. If, as individuals, we are surrounded by people who are primarily concerned with themselves, it is likely that we will have that same attitude. Therefore, if the agency in which we were trained stresses SALES, SALES, SALES without any other input, we could lose sight of the role ethics should play. When ethical behavior is not deemed important by our management and immediate peers, it is not surprising that problems eventually materialize.

It could be said that ethics are a recipe for living. Our code of ethics gives each of us our personal rules and values, which determines the choices we make each day of our lives. These choices affect not only ourselves, but everyone around us. Some types of ethics tell us what not to do (it is wrong to steal, so we must not do so). Others tell us what we ought to do (be kind to animals). In addition, there are those ethics or morals that actually take us beyond the basics of moral obligations. Mary Mahowald, a medical ethicist at the University of Chicago, calls this added ethical stand virtues. Virtues might be referred to as going beyond the call of duty. It may also be referred to as moral excellence. Such moral excellence would include those who have no legal or moral duty to another, but go to extremes to help them anyway. It refers to the person who gives their life for a stranger or goes to other countries to work for people they do not know, even though there will be no financial rewards at all. Virtue is going beyond what we are obligated to do.

Ethics is never a separate part of our lives. It is part of everything we do and everything we say. Ethics determine how we treat those we know and how we treat strangers. Ethics determine our actions in financial and public matters. Ethics belong in every profession and are especially needed in some. Because ethics, as a subject, is so broad and complex, it may sometimes be divided into sections such as personal ethics, religious ethics, legal ethics, professional ethics, medical ethics, business ethics and so forth.
Ethical neutrality is not possible. Rather, when ethical neutrality is stated by an individual, it seems to be a way of avoiding some particular issue.

In today's lawsuit prone society, the wise insurance agent or brokerage will make a point of following state regulations, but ethics actually goes beyond what is simply mandated by state or federal governments. Ethics define who we are. A man who tells constant lies is known to others as a "liar" (although studies show that 90 percent of us lie regularly). A man who steals is known to others as a "thief". An insurance agent who is unethical will also earn a reputation for such.

It has been said that legal authorities may be able to mandate behavior, but not ethics. Technically, this is probably correct. A person who would like to steal may not do so because of the consequences such behavior would bring about. Therefore, his behavior is controlled, but his ethics are not. Although he does not steal, he would still like to.

Controlling a person's behavior may, however, eventually lead them to an understanding of ethical behavior. It is not unusual for an individual to become the person they pretend to be. A person who acts ethically, even if they do not desire to be, may eventually soak in the ethical behavior and adopt some of that potential. In fact, since morality is about the way we live, we do learn it over our entire lifetime. To think that a person who is not ethical today will never be ethical is simply wrong. In fact, it could go the other way as well. The person who is behaving ethically today may not do so tomorrow. Even so, it seems to be true that most of our ethical behavior is learned during childhood and adolescence. Perhaps that is why ethical parenthood is so vitally important in the eventual outcome of our children's lives.

Children learn from what they see and hear. Children and animals tend to be very good at sensing adults as they really are. Children also tend to imitate the behavior they see, especially if it is coming from the adults that are close to them, such as parents. As a result, parents who set good moral or ethical examples are teaching their children to do the same. Unfortunately the reverse is also true. In homes where prejudice, racism, sexism and other immoral codes are practiced by the parents, children from those homes are very likely to act in the same manner. Children learn from what they see, good or bad. We have all heard adults say "Do as I say, not as I do." The chances are, however, that the children will do as they do.

It seems to be a popular notion that toughness is needed in the business world. Ethics may be perceived as a quality that does not belong to toughness. This is actually far from the truth. As many religions will be quick to confirm, toughness is often a vital part of ethical behavior. Children are the first to realize this. Peer pressure often demeans behavior that is ethical. Certainly the child that can withstand the stress of peer pressure is displaying toughness.
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To some measure, toughness is probably necessary to succeed in business. The insurance salesperson that cannot take repeated rejection will not likely stay with the insurance industry; at least not as a salesperson.

Toughness that is coupled with a code of high ethics may not always experience smooth sailing, but it is likely that the combination will produce an atmosphere that promotes business and that is always desirable. Toughness with ethics gives a passion for productivity and efficiency, along with the spirit of competition, all of which contributes to the traditional measures of economic success.

America was founded on the beliefs of many people who questioned the actions of the countries they came from. Those looking for freedom, religion, the right to work, the right to own possessions and land, and the right to make their own decisions all came together to form America.

Many Americans at least partially arrive at their code of ethics through their religion. In fact, the Bible sets down many prescriptions for ethical behavior. The Bible is probably the best known source of sound ethical advice. Even so, not all have agreed with the concepts stated there. Karl Marx, the father of communism, called religion the "opiate of the masses." Even Sigmund Freud, the father of modern psychology, regarded organized religion as institutional "wish-fulfillment."

It is doubtful that any person is only good or bad; each of us has shades of each. We continue to learn as new ideas are presented and new experiences encountered. Unfortunately, if we have been poorly educated on ethical conduct, we might be faced not only with leaning the basics of ethical behavior, but unlearning bad conduct as well. We typically refer to our ethical code as our conscience, saying such things as “he has no conscience.” What we are really saying is that the person has no ethical code or that his code of conduct is opposite from ours.

This brings up another issue. Of course each of us believes our code of ethics is the correct one. Branding another as unethical is sometimes merely a disagreement as to what is right and wrong. Ethics are based on personal perceptions, not on scientific fact or the views of the majority.

Ethics are not always just a matter of how we think and act. Often it is also a matter of character. So many things come together to form our character that all must be taken into consideration. Values, principles, emotions, plus many other factors all contribute.

There is little doubt that each of us is influenced by others. Even so, for each path chosen, we alone must take responsibility (again, it comes to personal accountability). Each of us has the ability to build, change, or destroy our own character. Part of our character is, of course, our ethical guidelines.
It should be noted that no single act defines our personal character. Each of us has likely participated in an act that was wrong. We may even have acknowledged to ourselves that it was wrong at the time of participation. That one action does not define our total character just as one kind act does not build our entire character. Character is more a matter of adding and subtracting our actions and thoughts. A good person can do something unkind, yet still be a good person. A person who normally behaves badly can do something kind for another and yet remain basically an immoral person. We refer to these isolated deeds as being "out of character." An action that is not consistent with one's normal behavior is not likely to form or change the character of a person (although that single action can affect another in either a positive or negative fashion).

**Companies Set Guidelines**

No business can exist without establishing guidelines. Every aspect of business does so. Guidelines include, of course, office procedures, sales procedures and simple conduct. They also include a code of ethics, whether that code is written or merely implied. Every business tells their employees what actions are right and wrong. It may be as simple as stating that overtime will not be paid unless properly authorized, or it may be as complex as a manager who turns his head when a forgotten signature is forged on an insurance form.

Ethical decisions are made every day in the workplace. These decisions will affect the quality of work performed, employment opportunities, safety of workers and products, advertising, and simple day-to-day operations.

It is encouraging to note that businesses across our nation are responding to ethics and community values. Most large corporations in the United States now have a written code of ethics. This trend is growing. Additionally, speeches of chief executive officers and annual reports are containing talk of ethical needs and approaches in business. Whether this is window dressing for the public or a real move to business values may be debated, but certainly the knowledge of ethical actions exists.

Some of the open talk of ethics in business has to do with money: companies have been sued over negligent actions with increasing court awards. Companies can no longer afford financially to ignore ethical issues.

A business owner must be aware that without employees who are ethical, the only restraint is the law. Without ethics, any business transaction that was not witnessed and recorded could not be trusted. This would certainly cripple a business if employees could not be trusted. On the other hand, when employees cannot trust their employer to be fair, problems can also develop. Those who own and manage the business must demonstrate ethics, fair play, and community involvement to financially protect themselves and their company.
Sometimes, unfortunately, it is the business owners themselves that turn out to be untrustworthy. There have been some American businesses (although a significant minority) that have been involved not only in unethical activity, but illegal activity as well.

We are almost at the point of expecting unethical behavior in some areas, such as the government, which is probably the first step in allowing it to continue. If we believe it can’t be changed, then it won’t be changed.

Government fraud is usually called public corruption and it is becoming an accepted part of life by too many people. The most common types of government fraud is awarding contracts to workers who offer bribes or providing political favors of some sort, voter fraud issues, embezzlement cases, subsidy fraud, and accepting illegal kickbacks.

Too often such government corruption has the potential of affecting public safety. For example, a former contract employee of the U.S. Army Corps of Engineers and a dirt, sand, and gravel subcontractor were both convicted of conspiracy and bribery in connection with a $16 million hurricane protection project for the reconstruction of the Lake Cataouatche Levee south of New Orleans. This levee is an eight mile section that is the system's lowest and most vulnerable stretch protecting citizens of Jefferson and St. Charles Parishes. The convictions were the result of fraud investigations in the procurement of levee reconstruction contracts.

Of course we are all aware of the failings of the banking and mortgage industry. The subprime lending crisis and resulting credit crunch resulted in significant losses and many lawsuits involving the mortgage lending and securitization process. There were civil lawsuits, criminal and regulatory investigations, government efforts to correct the impact of the subprime crisis and credit crunch, and litigation and regulatory actions relating to the collapse of the auction rate securities market. Taxpayers will be covering the numerous bailouts for decades.

The inspection of Wachovia Securities caught many of us by surprise, perhaps even Wachovia Securities. Securities regulators from six states began an inspection on July 17, 2008 as part of a probe into the company’s sales of auction rate debt. The inspection was triggered by their failure to comply fully with information requests from Missouri securities regulators.

Massachusetts sued Merrill Lynch over auction rate securities. The state alleged Merrill Lynch was committing fraud by pushing the sale of auction rate securities, knowing that the auction market was unstable.

Many of our clients lost their homes due to a collapsing housing market. Of course, some of the problems came not from fraud or shady practices but from over-eager buyers and mortgage lenders who turned a blind eye to their own accountability (there’s that
As we know, a **mortgage** is a loan made against real property with the intent being repayment as agreed by the borrower, under an amortization schedule until it reaches maturity. This would normally be interrupted only by significant life events such as moving, unemployment leading to bankruptcy, divorce, or serious medical events.

Mortgages were successfully handled by banks and lending institutions for many years using responsible repayment formulas. There were underwriting requirements to ensure that borrowers had the financial means to meet the repayment agreements. All the elements that could cause repayment failure, such as bankruptcy or serious life changing events were known by the actuaries that underwrote the loans, so risk factors were easily analyzed.

Consumers understood the concept that they were “sold” the house, but they did not consider the mortgage itself as being “sold” to them. Rather borrowers sought out the lending institutions and submitted loan applications. That changed. Advertisements came in full force on television, radio and in print. They promised that anyone could get a home mortgage regardless of many previously unlendable situations. Both banks and non-banks saw an opportunity and all seemed to want their chunk of the business.

Why did lending companies want to extend credit to those surely doomed to repayment failure? Because they were lending on the premise that the majority of these loans would be refinanced or the debt would be sold. Consumers often fail to realize that “debt” is a commodity that has value in the financial markets. Consequently, the following “concepts” were accepted by even normally sound lending institutions:

1. Down payments, signifying the ability to save and plan for the future, were no longer required. Many lending institutions would lend 100% of the home value.

2. Lending institutions made the assumption that few, if any, of the borrowers planned to keep the loan to maturity. In other words, they would either refinance or sell the home prior to the loan being fully paid off. If the borrower’s refinanced, it was likely to be with the same lending institutions. Borrowers were encouraged to utilize loans they might not otherwise have used, such as interest only loans. This allowed borrowers to buy more expensive homes than they would have ordinarily qualified for.

3. Borrowers were qualified based on the amount of the initial house payment – not the total loan amount. Therefore, banks and other lending institutions knew the borrower’s would be forced to refinance in many cases because they could not afford the increasing cost of their house payment. Initial “teaser rates” went up over time, causing often dramatic increases in monthly home mortgage payments.

4. Finally, many lending institutions did not qualify the borrowers to the extent that had always been done in the past. Some were jokingly saying that the borrower’s pulse was good enough. In effect, some loans simply took the borrower’s word
that he or she could afford even the initial house payment. Many of them could not even afford that initial low rate, but the lending companies did not care. It was a matter of getting their initial commission and moving the debt along to the next company.

These loans were not based on the home’s equity because no down payment was required in many cases and loan amounts were therefore on the full value of the home. Of course, many expected the rising housing market values to continue to rise despite signs that it was getting ready to cap. In fact, people bought second and third homes on the premise that they would be sold within two years for profit based entirely on rising home values.

Many of us thought these were new ideas that just didn’t work, but that is not the case. In the 1920’s similar lending practices were used and had basically the same results in the 1930’s when the housing market dropped. While consumers may have thought these were new practices, responsible lending institutions were well aware of what happened in the 1930’s. Because it was common knowledge in lending circles, it was difficult to sell mortgage-backed securities based on ballooning rates without an extra yield premium, so some lenders simply lied.

Of course, not all lenders were unethical. Many lenders continued to work with sound lending practices, including some surprising lenders who were lending to those with even low credit scores. They continued to require down payments and verifiable incomes that were likely to continue into the future (meaning they had stable jobs).

One might ask how this could happen since it was already experienced in the 1930’s. Didn’t the government correct the possibility that it could happen again? Actually, yes they did but the law was ignored. Title 12, Sec. 1831o mandates banking regulators take prompt corrective action regarding any troubled bank. The law mandates specific actions well before the bank faces failure. It further states that a troubled bank must “restrain senior executive compensation” meaning no bonuses or raises. Obviously this law was successfully ignored not only by the banks, but the regulators as well.

Unethical practices are obviously continuing today; some years have not necessarily just been bad years for ethical conduct. Writer Robert Peston wrote regarding Wall Street: “The underlying cause of the current global financial crisis is a system in which there’s little personal responsibility for lending decisions.” There it is again: responsibility.

In the case of the home loan problems, much of the driving power came from commissions for issuing home loans. Many of those issuers did not work for the banking and lending institutions, but rather were paid on the volume of mortgages they arranged.

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1 8/20/08 Corporation Watch
The incentive became production rather than quality. Rather like the insurance broker who wants insurance applications, not necessarily qualified applicants.

Have you ever wondered where all these bad mortgage loans end up? The paperwork and administration duties are handled by specialist companies, such as New Century Financial, which has already gone into bankruptcy protection. The debt itself ends up on Wall Street with such banks as Goldman Sachs, Morgan Stanley, Merrill Lynch and others who take the debt and process it into asset-backed securities or bonds. The banks themselves may have no connection to the actual creation of the debt; they merely handle it once it is there. They do not know if the debt is secure or not (if it will be paid as required or default). Debt is a commodity that is bought and sold without regard to those owing the debt. The banks do have historic data but due to the types of loans that were being generated such historic data may be worthless.

The companies will assess the risk value of the bond or security based on the data on hand, so accurate verification of the risk may not be possible. For a fee, special credit rating agencies, such as Standard & Poor or Moody’s will verify what they believe to be the correct risk rating, but unless they have better data such a rating is obviously flawed. As a result many of the bonds and securities have received inaccurate ratings so those who invest in them are receiving flawed investment advice from those who sell them. Data may eventually emerge allowing a more accurate prediction of the risk involved for investors, but by then it will be too late for many people.

Unfortunately for investors, not all involved have done their best to provide accurate risk assessment. Since many investors do not want any part of the mortgage industry, some have become creative when marketing these bonds. Sometimes they have been mixed with other bonds in collateralized debt obligations to hide the risk involved. As the mix becomes more muddled, additional investors (believing they are avoiding mortgage debt) will actually be purchasing in part the very thing they are trying to avoid. Some have branded mortgage debt “toxic waste.” As a result of these “mix and measure” bonds, many large investors are simply avoiding bonds entirely. The mixed bonds have been sold worldwide so it is actually affecting global finances to some degree.

If I have given the impression that only American institutions have performed shamefully, that is not the case. This has been a global financial issue in one form or another. It is not something that the general investor is going to unravel.

A survey conducted some years ago by Business Week stated that 59 to 70 percent of managers feel pressured to compromise personal ethical views in order to achieve corporate goals. This perception of pressure seemed to be especially high among lower level managers. On the positive side, 90 percent of the managers said they would support a code of ethics in their business place and the teaching of ethics in business schools.
Even a normally ethical individual can be influenced by unethical pressure from others, especially upper management. In today's economic climate, individuals often feel they would be unable to survive financially if they lost their job. As a result, he or she may be willing to participate in an activity once hired that they would not have participated in prior to being hired.

It is interesting that the FBI shifted agents from terrorism activities to work on Wall Street investigations, including one into the fraud of Bernard Madoff. Apparently we have decided that the threat to our society is higher from the financial sector than it is from the more physical terrorists.2

Laboratory research has shown unethical behavior rises as the industry or climate becomes more competitive. Perhaps that is why some insurance agencies push competitive contests and look the other way when activities seem to compromise ethical behavior. These studies further indicated that when unethical behavior is rewarded (as with prizes or additional commissions) it further erodes ethical standards. On the other hand, the same studies noted that when unethical behavior was punished, unethical behavior was deterred.

Those who study the rise and fall of ethical behaviors have made some observations: it is necessary, if one wishes to preserve ethical behavior, to require:

1. A sensitive and informed conscience;
2. The ability to make ethical judgments individually; and
3. A corporate climate that rewards ethical behavior and punishes unethical behavior.

Most ethicists believe that the more complex our society becomes, the more we need to teach ethics to the general population. In the past, ethical behavior was primarily taught to children by their parents and churches. As families became more complex and spread out, ethical teachings seemed to diminish. Some studies have suggested that the loss of grandparent interaction is partly responsible for the loss of ethical teachings.

There are probably multiple factors causing a perceived decline in ethical behavior. For example, when people interact face-to-face with others, there is less temptation to be dishonest. When we do not see or know the person we are dealing with, dishonest activity becomes easier. It is simply easier to cheat an individual we do not personally know.

**Example:**

**Scenario #1:** Betsy finds a large sum of money on the bus. There is no obvious person who left it behind. The honest thing, of course, is to turn the money in so the owner can be found, but statistically Betsy is likely to keep it.

2 Business Today; December 21, 2008
Scenario #2: Betsy finds a large sum of money on the bus on the seat an elderly woman had been occupying. Betsy had briefly chatted with her and learned she was on the way to see her new great grandchild. Having had a personal connection with the possible owner of the cash, statistically Betsy is more likely to turn the money in to authorities.

Promoting Ethical Behavior

Ethics is not entirely about oneself; it is also about others. It is not so much what one knows that makes an individual ethical, but rather what he or she understands. We all know it is wrong to steal, but understanding how stealing harms others is more likely to promote ethical activity.

Making ethical decisions addresses four basic issues:

1. Is it possible to teach others ethical behavior?
2. What is the scope of ethics?
3. What does it take to be a moral person?
4. What are a person's responsibilities to other moral persons?

There is no doubt that each of us, regardless of our occupation, faces ethical issues on a daily basis. Those in an occupation with a "public interest" are especially faced with ethical issues and probably legal consequences.

Ethics are standards to which an insurance agent or broker must aspire to; it is accepting the ethical commitment owed to each client. Every type of profession has an informal code of ethics, which may sometimes be more understood than written. Ethics are a means of creating standards within any given profession to upgrade it and give it honor. It is a means of measuring performance and acknowledging outstanding individuals. Ethics are often a means of providing priorities and building traditions based on integrity.

It would be hard to imagine doing business with anyone that we knew to be unethical. Can you imagine turning over control of your financial affairs to an attorney convicted of stealing from his other clients? Would you buy a car from a person who had knowingly lied to others about the cars he represented? Would you deal with an insurance agent who had repeatedly misrepresented the products he or she sold? Ethics are the only element, other than legal mandates, that add an element of trust to many industries. It is very difficult to mandate ethics. Only behavior, as we previously stated, may actually be mandated. If a person is ethical, that is something within themselves that simply adds to their trustworthiness.
No matter what our profession may be, as individuals, each of us faces ethical issues each day. Some are very simplistic in nature while others are complex and may have many sides (and many correct answers) to them. We face moral issues every day. Such questions as: How much should I give to the poor? Is it wrong for me to take drugs? Should I report someone who is cheating are daily concerns.

Some types of ethical or moral questions can be directed to our religious institutions for support in determining the right answer. Sometimes the answers can be found in our legal system. If our state or federal government says commingling funds is illegal, for example, then we could also state that it must be unethical as well. Sometimes, determining what is ethical is simply a matter of what feels right emotionally. We have all said or heard someone else say "It just doesn't feel right." That feeling of right and wrong is probably the result of our childhood upbringing. Even if we do not distinctly remember being taught that a particular action is either right or wrong, somewhere in our upbringing or past experiences, we have received such teachings.

While this course cannot instill ethics into anyone who has none, it may provide the tools for determining the more complex issues. By using basic concepts and theories and by having an appreciation of what constitutes an ethical solution, decisions may be made on the basis of reason.

It should be noted that different conclusions may be reached to the same ethical question. It does not mean that one solution is right and another wrong. Ethical questions often have multiple answers, all of which may be correct. Many ethical questions involve multiple hues; some decisions may be based solely on facts, while others may be based less on facts and more on emotional factors (or what simply feels right).

Business leaders often question whether ethics may be taught in the workplace. This, of course, depends upon multiple factors. First of all, does the employee desire to be ethical? As with all things, the person must want to achieve the goal at hand. If other goals are more important to the individual, then it will perhaps not be possible to teach ethical behavior. If however, ethical behavior is important to the individual, even if other goals are also sought, ethics may be taught. Unfortunately, those who are faced with the responsibility of hiring personnel can seldom determine the individual's ethical desires.

Sharing is one of the first lessons a child learns. Sharing is a form of ethics; it is the opposite of greed. As adults, we learn to share in numerous ways, but sharing begins in childhood. The shift from securing our own interests to sacrificing on behalf of others is an essential part of what is meant by "ethical decision making." This may especially come into play for insurance agents. The choice to make a sale and earn a commission in any way necessary rather than sacrificing the sale on behalf of honesty is an ethical decision. The selfish person cannot routinely make such moral decisions, or perhaps more correctly will not, make such decisions.
It is necessary to understand that one of the general features of taking an ethical point of view is a willingness to take into account the interests, desires and needs of others. A person may argue that it is necessary to look out for one's own interests, desires and needs. While this is certainly true to a point (we must cloth, feed and house ourselves and our families), taking our own interests into account need not mean making unethical or immoral decisions regarding others. Even commission salespeople are able to make a very good living while still maintaining ethical behavior. In fact, the best salespeople do not need to behave unethically because they have mastered their trade through the development of communication skills and professional training.

When a child asks his or her parent "Why do I have to share my toys?" the reply may be "Because if you don't share your toys with your sister, she will not share her toys with you." This simple logical answer teaches the child a valuable lesson. Our interests are tied to the interests of others. Just as our ancestors had to protect one another to survive, we must treat each other ethically so society and all that involves can survive. For example, if only those who wanted to pay taxes did so we would not have free schools, decent roads and bridges, emergency services, libraries, and many other luxuries that exist solely due to the taxes we pay.

Every aspect of our society is built on the premise that it must be ethically run for the good of those who cannot adequately protect themselves. Our laws protect the weak, the less educated, and the unusual from others. We know the system is not perfect; there will always be those who cheat, lie, and steal. There will always be those who kill others, those who harm themselves (through drugs or alcohol), and those who cannot look beyond their own self interests. Even so, our society runs pretty well as long as we are constantly vigilant about enforcing ethical behavior. When we fail to act ethically there are unfortunate consequences, as seen in the housing and loan markets.

Just as the man who is known as a liar or a thief will find others unwilling to trust him, the insurance agent who is not ethical will, at some point, find making a living impossible because no client will wish to deal with him. We are better able to achieve our goals when we recognize the goals and interests of others. Plato argued that immorality (unethical behavior) is ultimately self-defeating. While the con artist may not believe this and some unethical people do seem to prove the point, most people believe that, at some point in time, each person receives what they have given. The Bible says we will reap what we sow. Even if we do not get back what we give others (whether that be good or bad), most people would agree that it is easier to be happy with ourselves when we feel we have done the right thing.
**Egoism**

Not everyone believes it is in their own self-interest to be ethical in their behavior. Some who reject the idea of other's interests and desires are called egoists. Do not confuse this with egotism. An egotist is a person who is self-absorbed or stuck on themselves. These people make poor egoists. Webster's dictionary defines *egoism* as the doctrine that self-interest is the basis of all behavior whereas *egotism* is the habit of being too self-absorbed, talking too much about oneself or conceit.

Psychological egoism maintains that people are *always* motivated to act in their own perceived best interest. Psychological egoism is not an ethical theory since it does not tell people outright *how* to behave. Rather it attempts to explain *why* people behave in certain ways. Ethical theorists consider this theory, however, since it does have a bearing on their theories of ethical behavior.

Another version of egoism is a genuine ethical theory. Traditionally named "ethical egoism," it maintains that people *ought* to act in their perceived best interest. An ethical egoist argues that people should act in their best interest at all times because it is good for the general economy (providing industry and jobs, for instance).

In the marketplace we all try to buy low and sell high. That is certainly an attempt to pursue our own self-interest. It is unlikely that the buyer worries about the seller when buying low, nor does the seller worry about the buyer when selling high. Individual self-interest is at work. Even though this may be an excellent example of ethical egoism, it tends to be both orderly and productive to our society. This points out that this theory has positive dimensions to it despite the selfish basis.

A political economist, Adam Smith, believed in ethical egoism. He felt that people, while being interested in their own needs and desires, created good for society as a whole. Smith felt that economic conditions were created and expanded when people acted in their own behalf.

If we were to fully believe in psychological egoism, which states that humans automatically act in their own behalf, many of the acts of heroism that we see could not be explained. Examples of individuals giving their own life for that of a stranger could certainly not be explained by psychological egoism. Nor could the actions of entire communities that come together for the benefit of a stranger in need; the groups that build houses for someone they do not know, organizations that put their time and money together to build a playground or help abandoned animals are putting themselves second – and enjoying every minute while doing so.

There is more day-to-day heroism than one might realize. Such simple things as the child who shares his lunch with another student, the woman who gives her last dollars to
a homeless person, the man who donates his only day off for a food drive are all acts of kindness that consider the needs and desires of others first.

**Is it possible to teach ethical behavior to others?**

Many feel it is possible, though perhaps not in every situation. An agent who has never considered ethical behavior might suddenly begin to do so if the agency where he or she works begins a strong ethics campaign. On the other hand, an agent might continue to act unethically even if threats are made to recall his or her license to sell insurance. One thing is certain: the effort must be made to emphasize ethical behavior because there will always be those agents who will respond favorably to such efforts.

**What is the scope of ethics?**

This is an expansive question that could be carried to great depths. In many industries, including the insurance industry, the professionals have knowledge that the general population does not have. As a result, those individuals who seek out the professionals must rely upon their honesty and integrity. Therefore, a feeling of ethical standards must exist. It was the potential for abuse of power that provided a set of rules for what is commonly called "ethical behavior." Sometimes, ethics are written standards, which may be mandated by law on either a local or federal level. The premise, upon which practical ethics must be based, is that power must be exercised in the interest of the clients who seek the professionals out and may not be exercised solely in the best interest of the professionals themselves.

Parts of the insurance industry have been labeled (often unfairly) as lacking ethical standards. Usually what we find is not an industry as a whole without ethics, but rather some individuals who have received much publicity. The insurance industry, which deals with senior products, is one section that has received bad publicity off and on. Part of this has to do with the age of the consumer. If a 25-year old person is taken advantage of, many would think he was simply stupid or uneducated to have allowed it. If a 75 year old is taken advantage of, however, publicity is sure to follow. This is not surprising since a 25 year old is more likely to have the ability to make sound judgments in comparison to a 75-year old person. Also, our older population controls most of the nation's wealth. If a salesperson (in whatever industry) is greedy and unethical, he or she is most likely to hit those with money. That would typically be older people.

We should also ask ourselves why society seems to consider it less offensive to take advantage of a 25 year-old person. If unfair advantage exists, why does it matter how old or young the victim is? Perhaps that is an ethical question in itself.

When we look at what the scope of ethics is or could be one might be surprised at the extent to which it could be taken. Even our financial investing may be an ethical issue. For example, if an agent were an animal activist, would it be ethical for them to invest in
companies that use animals in the laboratory or for testing? If a client is an environmentalist, should he or she invest in any type of investment that is detrimental to the environment?

People and cultures do not always agree on what is ethical. What one culture or society may consider ethical another may not. Even within the same culture or society, people may disagree on what is and is not ethical. America fought a civil war over a strong ethical disagreement.

Every person probably has some degree of greed or selfishness within them. The ethical person realizes this possibility. Since ethics is a code of values to guide man's choices and actions, the ethical person will bypass their own greed and do what is perceived as best for the majority of people or best for the person they are dealing with. In choosing his or her actions and goals, constant alternatives are faced. It is not always easy to decide which choice is best and ethical. Without a standard of values, ethical choices would be very hard to make. At some level, our religious background may set the standard of values by which we make our choices. However we arrive at it, understanding how others feel determines many of our ethical decisions.

What does it take to be a moral person?

Most people know right from wrong. While what is right may not always be agreed upon, as long as a person acts on what they perceive to be right, then they are acting ethically. For most people, there will be little disagreement since most of us are not involved in the global ethical questions. Most of us deal with the simple things in life – earning an honest living, paying taxes, supporting our families, giving to our churches, helping our elderly parents, and all the other aspects of daily life. Our quest for ethical guidelines is mostly black and white. We don’t have to address the issues on Wall Street or help the President solve world peace.

The ethical person believes in doing what is right. He or she doesn’t have to think about it; they know the path to take. The ethical insurance agent does not believe it is necessary to trample their potential clients in order to get the sale, they do not believe it is necessary to tell half-truths or leave out needed information. Of course, it is also necessary to be well prepared and use good communication techniques. All types of professions benefit from these skills.

It is not possible to be one person at home and another person at work. Who we are is defined everywhere we go and in everything we do. Three questions must be addressed:

1. What kind of person am I?
2. What quality of work do I want to perform?
3. What do I want my legacy to be?
Just as a man is defined by the lies he tells, and a thief by his actions, all of us are defined by our daily activities. We do not necessarily have to be a liar or a thief to define ourselves as less than honest. Many of our political figures are not wholly dishonest and yet they are not perceived to be honest either. How do we want ourselves defined? Answering such questions cannot be avoided. Even when we try to ignore them, we are still answering the questions by our actions. It must be realized that the questions are asked in the minds of every person we come in contact with. They look at us and they form opinions to these questions. Coming to terms with the basic philosophical questions about what we are doing with our lives may be the most practical of all possible ventures.

If we have children, we know they are very good at defining those around them, including their parents. Children may not voice the image they see, but little is missed. How do you wish your children to view you? What you do in your every day lives will form their opinions. It will also demonstrate to your children what path in life they might take.

Perhaps the worst image some children receive from their parents is that of violence, whether against them or each other. It is difficult to understand how an adult would allow that type of personal action to exist, whether it involves striking a spouse or child. Verbal abuse is just as damaging. While it may not show as prominently as physical abuse, the effects last for a lifetime.

**What quality of work do you want to perform?**

Quality of work includes how we treat our clients, perform the necessary insurance duties, including required continuing education, and the effects of the policies we place. It is quality, not quantity of work that counts. Forging signatures, misstating health conditions, omitting information for the sake of a sale, and so forth, determines the quality of one’s work. True professionals simply feel their integrity is worth more to them than a quick commission. We all occasionally make mistakes and that is not a reflection of quality unless we do nothing to learn from the error. If an error occurs and no effort is made to correct it, then that would reflects on the type of work performed.

**What do I want my legacy to be?**

Most of us must surely want to be remembered in a favorable light. I doubt we go through life worrying about it, but we also don’t want people standing around our grave saying “I sure am glad he’s gone!” I remember a friend saying about an especially mean family member: “I showed up at the funeral just to make sure she was really dead!”

Those who proclaim the loudest that they don’t care what anyone thinks probably care the most. Most of us want to be remembered in a favorable light. We want our children
to keep our picture on display; we want our grandchildren to talk fondly of the time we spent with them; we want our friends to remember the good times.

While the legacy that matters most is the personal one we leave our family and friends, we will also leave a business legacy. Hopefully it will be one of competency. Of course, most people would not view themselves as incompetent even if they were which is why the industry is supposed to remove those that are incompetent. Sometimes, competency is merely a matter of obtaining required or necessary education within any given industry. It is always interesting to note the amount of sincere education acquired by the leaders in an industry. The leaders are nearly always more concerned with educating themselves to a greater degree than are those at the bottom. Education and ethics go together. It should be noted that *success* and education also go hand-in-hand.

**The Leaders of the Pack**

It is unlikely that most agents would consider *who* they work for to be a matter of ethics. However, as many industries have shown us, it can be. When ethical behavior is not deemed important by the company individuals find themselves following the pack. When an individual feels their day-in, day-out role is primarily connected to making money without any regard as to how the money is made, ethics may easily take a back seat.

How does an agent know, except in the extreme cases, if their agency lacks ethics? It may not always be a black-and-white situation. Sometimes the decision can only be a personal one if the agency is not noticeably to one extreme or the other. One would not expect an agency or brokerage to be outright unethical. Each state has mandated certain procedures that a company must follow which usually prevents outright unethical behavior. It is more likely that questionable companies would ignore unethical actions of their agents, which would equate to condoning such actions.

Some examples of this might include:

**Example #1**

Joan, an insurance agent, is sitting in the agent's room of the agency where she works. As she is completing her paperwork on the business she has written that week, she notices that she forgot to have one form signed. Another agent in the room, Matt, suggests: "Don't worry about it. Just put one of his signatures against the window pane and copy over it onto the one you need."

Joan: "Isn't that illegal?"

Matt: "Maybe, but everyone does it. If you're not, then you're the only one who isn't."
As Joan asks around, she discovers that Matt is correct. Virtually everyone she spoke to about it confirmed that they too copied signatures where one was forgotten. Joan found that nearly every agent intended to get all required signatures, so it was not a matter of purposely omitting them. Rather, it was an easy way to perform below necessary levels of competence. Several agents even mentioned that the management had sometimes been present when signatures were copied. They simply left the room and acted as though they had not seen it.

Of course, it is unethical to copy any signature in any situation. It is also nearly always illegal to do so. In this case there are additional ethical questions involved. Is Matt unethical for advocating that another person forge a signature? Is the agency unethical by ignoring the behavior going on? By ignoring the behavior, is the agency condoning it? If Joan had decided against forging the signature would she then be free of any other agent's unethical behavior? Or, having knowledge of unethical (and even illegal) activity, would she be ethically obligated to report it to the insurance department? Should she go elsewhere to work and leave it at that or, in the interest of ethical behavior and responsibility, should she report the behavior to the State Insurance Department and perhaps to the insurance companies as well? Since Joan had developed several good friendships among the agents, how would loyalty to her friends and her responsibility to ethical conduct intertwine?

As you can see, ethical behavior is not a simple matter. Do your standards of what is ethical apply only to yourself or to others as well? When views do not correspond to the views of others, who is right?

Example #2

John works for a large investment company. John is a strong believer in environmental issues. Because of his beliefs, he will not refer any client to any stock or company that John feels harms the environment. John seldom allows his clients to see any investment that he does not agree with. John's company knows that John will not present any company that he does not agree with. The company says nothing as long as John brings in a good quantity of business. If his business is down, however, they do bring up the matter.

Is it ethical of John to only show those companies that he agrees with? Secondly, is it ethical of the company he works for to only be concerned about it if his sales are down? Could John ethically represent companies that he opposes? Which set of ethics should come first: his own or his responsibility to his clients to allow them to make their own choices?

If the company that employs John should require that he show all options to their clients, is John ethically bound to follow his employer’s requirements? Whose ethics
come first: John's, the client's, or the employer's? Different people or groups often do not agree on what is or is not ethical. Who should decide which ethics come first? This question might come under the heading of "What are a person's responsibilities to other moral persons?"

Basically, all of these concepts or questions bring us back to the original point. A person must know why they are doing a particular thing. In the case of selling insurance, if the agent does not understand the reasons why insurance policies are important to own, it would be very easy to lose track of important ethical elements. The lack of this understanding might eventually force the agent to deal with the basic inquiries that come about when ethics are pushed to the background.

**What are our responsibilities to other moral persons?**

Most people realize that they are responsible for their actions. In sales, we often hear the statement "For every action, there is a reaction." This is generally true in life as well. It goes beyond the obvious situations (if you smack someone, they may smack you back). If you are rude to a person, you may not realize the "reaction" at that moment, but one will surely follow. The reactions may not always be noticeable to others. This is especially true when it involves emotions, such as hurt feelings. Since each of us is responsible for our actions, the question then is “are we responsible for the reactions that follow?"

Some reactions are directly tied to our actions and are predictable. If we lie in order to obtain money, our actions are then directly tied to the reactions that follow. What we did was deliberate and the results should be no surprise. In such situations, we are responsible for the reactions to our actions.

In other situations, we cannot be responsible for the reactions. If we act in a responsible manner and a reaction occurs that hurts or offends others, we may not necessarily have any responsibility. What a person does in every day life is the result of multiple decisions made over their lifetime. Those decisions include our perception of whom and what we are. Our character (or lack of it) is made up of our day-in, day-out decisions. The irresponsible person will not care what his or her responsibility to other moral people may be. Therefore, we will look only at what an ethical person's responsibility is towards other ethical persons.

Let's look at the example of John, the investment counselor. He would not present any investment to his clients that he did not personally agree with. Let us assume that most of John's clients are themselves ethical people. Since his clients are themselves ethical, is John wrong in making such investment choices for them without giving them a chance to bring out their own sets of ethics? **What is John's responsibility to other moral or ethical persons?**
Moral or ethical responsibility is not a single choice. Such choices are made daily in many things that we do. If we assume that our children are basically moral people, then what are our responsibilities towards them? This may also be said of our peers at work. If the majority of the agents at the firm we work for are ethical people, do we then owe it to them to also be ethical?

Agency XYZ prides itself on being ethical. The owners and managers stress such behavior at all company meetings. While sales are certainly promoted, it is made clear that the sales must be honestly come by. XYZ Company seeks out the very best products available so that their agents can present a superb policy to their potential clients. Training and education is given a top priority by the company as well.

It would probably be safe to say that XYZ Company has invested not only time but money into their company and their sales force. Since they have stressed ethical behavior, it is also probably safe to say that they do not feel such behavior will hurt them financially. In fact, they probably feel it will benefit them financially. Given this scenario, XYZ Company has probably attracted those insurance agents who also give a high priority to ethical behavior. If an unethical agent came to work there and misrepresented the products (theirs or others), XYZ Company, or any other aspect involved in the sale, how would this affect the ethical agents?

An agent once relayed this true story: she had been building a client base for about two years when the agency she worked for became the subject of an investigation by the state's insurance department. Since she had always prided herself on giving her best efforts to her job and her clients, it was distressing to see the agency she worked for on the evening news. It did not matter whether the agency had actually done anything wrong. It did not matter whether she had done anything wrong; she worked for the company and that was enough in the eyes of many.

In this same context, the agents at XYZ Company would be affected by an unethical agent even though the other agents were very ethical in their behavior. People believe in the old saying "It only takes one bad apple to spoil the whole barrel." Therefore, one unethical agent will affect how others in the same agency are viewed. In this context, every agent has a moral or ethical responsibility to all the other agents. In the case of the agency being investigated, that agency had a moral or ethical responsibility to all of its agents. Of course, it is the job of the state's insurance department to investigate any complaint. That certainly does not mean that anyone is actually guilty of doing something wrong. Chances are, however, if it hits the evening news or the newspapers, it will not matter whether there is any guilt or not. Opinions will be formed. Therefore, each insurance agent and each insurance agency has an ethical responsibility to act in a way that will not cast doubt on themselves or others.

Sociologists have contended that determining our own identity is not an easy thing. Many people never realize that we are able to choose who we are by the choices that we
make. Certainly, we are influenced by many things, some of which are beyond our control. Even so, most of whom and what we are, we determine ourselves.

**Objectivist Ethics**

Since reason is man's basic means of survival, it is not surprising that we have the ability to form who and what we are. This is called Objectivist Ethics. Since everything man needs has to be discovered by his own mind and produced by his own efforts, there are two basic elements involved in becoming the person we choose to be: **thinking and actions.** We decide who we will be and our actions carry out those thoughts. To be an ethical person, we must, through our thinking, choose to be so, and then productively work towards it.

If some people do not choose to make any conscience choice, they will develop by imitating and repeating the actions of those around them. This is why it is so important that agencies and management staff make ethical behavior a priority in the workplace. Those who simply repeat the actions of those around them seldom make an effort to understand their own work. Unfortunately, **who** is imitated is seldom a concern to these individuals. As a result, one bad apple can, in effect, spoil the barrel.

Those who do choose to think out their actions and work productively towards a goal still do, however, remain the main force. They are the people who are most likely to be copied by others. Even those who survive by using brute force, or by making others their victims in some capacity, survive only because someone else was thinking and working productively. In other words, con men survive off the thinking efforts and hard work of others. Those who use brute force to steal or loot, survive off the thinking efforts and the hard work of others. It all comes back to those who do use logic and conscience choice.

As a theory of ethics, objectivist ethics holds man's life as the standard of value and his own life as the ethical purpose of every individual man. The difference between "standard" and "purpose", as used in this context, can be important. "Standard" is an abstract principle that serves as a measurement or gauge to guide a person's choices in his or her achievements or specific goals. The goal itself or the achievements obtained become the "purpose". Probably every person has some "purpose" or goal in life, but not everyone would have a "standard" of life.

Pete was born very poor. This poverty made such an impact on him in his childhood that he now strives to become wealthy. He obtains his accumulating wealth by whatever means necessary. Although Pete definitely has a goal or purpose in life of becoming rich, he does not have any standards. There is little doubt among those who know Pete that he will become very rich. Along the way, however, Pete is not finding much happiness. He has not thought out the goals he has established. Pete knows what he is
doing, but he does not understand why he is doing it. Pete would be surprised (and perhaps even laugh) if someone told him that ethics are a part of finding happiness.

**Holding our Ethic Code**

Our history is full of wise men that wrote about the philosophies of life. While many of them did not agree on many points, most did agree on one: lack of ethics promotes disorganization, financial turmoil and, sometimes, even the demise of governments.

As individuals, we may often feel that we have little control over others. This is true to a certain extent, but we do actually have more control than we might realize. The control we have is the ability to choose our own way of life. There is little doubt that what we do on a day-in, day-out basis affects everyone we come in contact with. We are also impacted by others in the same manner.

The activities and policies of a business tell the employees what the firm's underlying values actually are. It will not matter what is written in the employee manuals. What the firm actually does will be the loudest indicator. Actions reveal more about a business than does executive speeches or advertising campaigns. The employees will judge the company by the way they are treated individually.

Is the way we treat others an extension of our code of ethics? Often we forget that ethical behavior is not only connected to such things as paying our taxes fairly, following the laws or telling the truth. Ethical behavior can also be connected to how we treat others. Ethics is a code of values to guide man's choices and actions. In choosing one's own actions and even goals, we must face constant alternatives. Even such things as the manner in which we speak to others are a part of our daily alternatives.

Selfishness is something that we expect from children, but not from adults. To be selfish is to be motivated by one's own self-interests. This concept can be applied to individuals or companies. Insurance agents are often accused of self-interest, but companies are probably the most common target of such claims. For an individual or company to center on their own self-interests, they must have considered what constitutes their own self-interests and how to achieve it. Because a selfish person or company chooses their goals through reasoning, selfishness is part of a goal to achieve self-gratification, wealth, or power by whatever means necessary.

Being ethical can be very difficult when being unethical appears more rewarding from a financial or public standpoint. The public standpoint is often overlooked. If we feel strongly about something that no one else seems to, it is very easy to keep quiet. In fact, that is precisely what gets "followers" into trouble. When a person knows something is not right, but no one else is saying anything, it is easy for the individual to simply go along with the group.
Greg works for a very large insurance agency. Greg has always had very strong religious convictions and, as a young man, took much teasing because of his views. Over the years Greg simply found that keeping quiet was easier. After all, he reasoned, as long as he personally held his moral ground, what others did was their own business.

Mike was also an agent with the same agency as Greg. As time went by Greg found mounting evidence that Mike was "clean sheeting" his applications. One day in the field Greg ran across one of Mike's clients. She was an elderly woman who obviously had some mental disorder. She could not remember simple things and was under a doctor's care.

Back at the office, Greg asked Mike how he ever got her on that policy, which was issued only 6 months previously. "I would not have even attempted it, given her medical situation," stated Greg.

Mike replied "I simply stated what she told me. If she didn't say it, I didn't write it."

On two other occasions, Greg found similar circumstances in Mike's business. Greg voiced his concern to Mike: "You know those people won't be covered if something comes up. The company will simply rescind their policy."

Mike: "You worry too much."

It became obvious to Greg that Mike did not intend to change his practices.

Since Greg is not involved and performs his job ethically, does he have any moral obligation to Mike's clients? Since Greg considers Mike to be a friend, does he have an obligation towards Mike?

Greg was so concerned that he went to his manager. The company's manager told Greg that it was not his concern as did several other coworkers. In fact, most people that he talked to within the company seemed to be viewing Greg as a potential troublemaker. Greg had heard about "whistle-blowers" and he knew he could be putting himself in a precarious position with the company if he became too vocal.

On the surface it would be easy to say that right is right no matter what. It is likely that most people would, however, suggest a different course for others than they would suggest for themselves. Studies have shown that people are more likely to voice ethical behavior than follow it.

The truth is, our identity is established by our actions (a liar is known for his lies; a thief is known for his stealing, etc.). A common pitfall to proclaiming ethics, but not following them, is that an identity is established. When we allow ourselves to be defined
by whatever we happen to fall into, that in itself is a choice. Who we are is established by what we do and even by what we fail to do.

Who we become is a gradual thing. Seldom are we formed by one single experience although one single experience, if great enough, can change our direction or focus in life. Change, for either good or bad, can be a gradual process. So gradual that people may fail to notice what is happening. Therefore, a code of ethics must be a daily goal that we deliberately choose to follow.

We often hear that Americans are the largest consumers of goods and services in the world. We have become a nation of buyers where we were once a nation of savers. Pleasure today is promoted over financial safety tomorrow. This attitude is natural; most people would rather have something now than later. Without a system of values, individuals may come to feel that society owes them a comfortable living in retirement. This rationalization allows them to spend today without worrying about tomorrow. Self-discipline and self-control have given way to self-fulfillment and material consumption. Businesses have also fallen prey to material consumption. Material consumption can often be translated into one general word: greed. It is the desire for more today.

Some might say being ethical is hard work, but others would disagree. Having a specific ethical code could make life easier since such individuals instinctively know who they are and how they wish to respond to any given situation. It removes the stress that might otherwise exist when decisions are necessary regarding personal or business actions. The beauty of freedom of choice is the ability to improve on past decisions; we are not permanently tied to what we have done in the past.

It is possible to discontinue acting in an unethical manner, or "mend our ways" as it is often referred to. It is never too late to begin to act in an ethical manner. In fact, John Newton, the man who wrote one of our most famous songs, was the captain of a slave ship. As he came to realize that slavery was wrong, he used his experiences to bring this same understanding to many others. The song written by John Newton was Amazing Grace. Knowing this, the words of the song gain a greater meaning:

Amazing grace, how sweet the sound
    that saved a wretch like me
        I once was lost
    but now I'm found
        was blind, but now I see.

While there are many reasons to perform ethically in business, the one that should matter most is our image to others. We are a reflection of our lives, our work, our families, our community and ourselves. Our children will copy us (that's hard to believe during their teen-age years, but it does happen), our families and our communities will be affected by our actions and we must live with ourselves. In fact, those around us,
including our coworkers, are affected by our values (ethics). Just as a follower may follow the cheater, he may also follow ethical behavior. When an agent defines their character as an ethical human being, it will show in his or her daily behavior, which includes his or her work. This will bring self-assurance, which will ultimately benefit him or her in many ways, including financially. Personal integrity radiates confidence and everyone prefers to deal with people who seem confident.

A few years ago, the Howard Fischer Associates (one of New York's top executive search firms) conducted a survey of CEOs of the top one hundred companies in the New York area. They were looking for traits most valued by industry leaders.

Of course honesty and fairness were ranked at the very top. These are the other character traits that were listed:

1. Never compromise on matters of principle or standards of excellence, even on minor issues.
2. Be persistent and never give up.
3. Have a vision of where you are going and communicate it often.
4. Know what you stand for, set high standards, and don't be afraid to take on tough problems despite the risks.
5. Spend less time managing and more time *leading*. Lead by example.
6. Bring out the best in others. Hire the best people you can find, then delegate authority and responsibility, but stay in touch.
7. Have confidence in yourself and in those around you, and trust others.
8. Accept blame for failures and credit others with success. Possess integrity and personal courage.

There are many books and so-called experts telling us how to achieve financial and business success. We are not here to say whether that advice is accurate or not. Even so, before accepting advice from others it might be wise to determine what one actually wishes to accomplish during their lifetime. So often individuals lose track of their true goals (rearing happy children, writing a book, or establishing a close family) and become side-tracked with the goals of others, such as the company they work for. When an individual loses track of their own goals, they are more likely to become followers. For business owners, including many self-employed insurance agents, it is easy to become consumed by earning that next commission. Always searching for another sale is, of course, necessary for financial reasons, but not at the cost of all else in life.

In an effort to become the super-salespeople our company, agency or management staff promotes, people tend to embrace a variety of roles. That might include optimum time
usage, aggressive sales techniques, becoming a superb team player, or motivational skills. Certainly all of these avenues can have advantages in one way or another. Each method does have its place in the business and sales world. Usually, each method that is promoted contains a certain amount of useful advice because they contain certain truths. That is precisely why these books tend to sell well. Even so, these methods, whatever they may be, also have their limitations.

Agents have complained that there seems to be something "missing" even when they have followed the methods precisely. Perhaps the why of our profession is missing. Why are you selling insurance - only to make a living? Do you understand where a product fits? Does the product do an outstanding job of meeting another's goal? If not, you have likely missed the why of your job. It is in the why that ethics or values often play an important role. When an agent understands the role they are playing in another's quality of life, the satisfaction gained goes hand-in-hand with ethical behavior. Clearly defined goals and purposes are essential if people are to understand what their lives in general and their work in particular are really all about.

It seems that psychology is the current rage in selling. While it may give an air of being scientific, often the "psychology" listed is more apt to resemble manipulation. When such techniques are encouraged by their employer, individual employees may feel inadequate to challenge the validity of them. This may especially be true if the concerned salesperson is not the "star" of the agency. Often, an individual may feel their job is not secure enough to question the techniques being pushed on them by their employer. Or, if the salesperson is not the super producer of that agency, they may simply feel that they have not earned to right to speak out. In actuality, ethics belong to everyone, not just the superstars of sales.

Totally fulfilling work probably does not exist. For many people, commissioned sales are something to be feared. It is probably safe to say that some amount of high self-esteem likely exists for those who enter the commissioned sales field. A person must feel they can succeed even to enter into such work. This brings us to another area of ethics. In this case, it involves those who recruit commissioned sales staffs.

Nearly every insurance agent has, at some time or another, had a company or person promise the world. The majority of workers do not enter commissioned sales. There must be a reason. If financial success were so easy, everyone would be doing it.

Can ethics be a part of promotional selling? At what point does reality need to be interjected? Should the fail rate be stated?

It might be easy to state that the "dark side" should also be stated, but would you expect that in other industries? Can you imagine a new car salesman saying: "Oh, sure, the car looks great now, but it won't in a few years. There will be wear and tear and the paint job will become dull. Five years from now you'll be glad to just get rid of the car."
It is common for agents to say that they would never have gotten into the business if they had known *everything*. And yet, now that they are in the business, they do enjoy their work. There are many aspects of commissioned sales that can scare a person out of ever entering it. Should these aspects be discussed with new recruits? There are no easy answers to these questions. It is safe to say, however, that overstating the benefits in commissioned sales is commonplace. Promoters often feel it is necessary to promise the old "chandelier in the barn" in order to bring in new salespeople.

There is no such thing as a *totally* satisfying job. Certainly it is desirable to find fulfilling work, but most things are a mixture of enjoyable and mundane. In other words, there are times that the job seems extremely fulfilling and there are other times when the job seems absolutely terrible. Even fields of work that seem to be glamorous to others generally carry with them a certain amount of negatives. Even jobs that promise excitement carry stretches of boring routine tasks.

Promotional advertising is all around us. As viewers of this, we must be aware that glamour and excitement also carries simple hard work and frustration. Look at the ads for joining the armed forces. These ads show handsome men flying planes or jets, standing on the decks of mighty ships, or visiting exotic foreign places. They do not show kitchen duty, strenuous marches, or dangerous duties.

There are so many temptations in life that ethics must remain a primary focus, especially in financial industries and commissioned sales. Even though it may seem to come effortlessly to a few, the majority must make a conscience effort to be ethical. Ethical people typically have a moral reason for being such. People who consider ethical standards to be a high priority also value such personality traits as patience and kindness towards others. In fact, whatever the career line, the most successful salespeople state that patience and kindness is necessary in their line of work. Some state this quality as a "love of people". Top-notch salespeople do, of course, develop the necessary skills for their jobs, but their love of people motivates them to do a better job than the average person. They tend to "go the extra mile" for their clients, even when that extra mile does not overtly bring them any financial rewards.

An individual who is naturally kind towards others tends to have a sensitive awareness of them. Kindness generally takes into account how another person might feel as a consequence of what we do. That is not to say that a kind person always sympathizes with others in every situation. Sometimes being kind means withholding sympathy. It does mean that empathy must be involved. Let's look at the difference:

*Sympathy* (noun): (1) fellow-feeling; compassion. (2) condolence. (3) agreement; approval; accord.

*Empathy*: (noun): (1) the complete understanding of another's feelings, motives, etc.
Not all will agree on the need for sympathy or empathy. Sympathy may not necessarily help a person and may, in some cases, increase the existing problem. Empathy tends to be aimed at correcting a given situation, and may be described as "tough love".

When a person is discharged from their job, personnel managers report that they often try to soften the blow by being less than honest about the person's shortcomings. In addition, they often do not tell the next potential employer the true reasons they were discharged.

Such evasions of the truth may do more harm than good. Unless the person knows and understands the deficiencies and mistakes that led to the loss of his or her job, those deficiencies and mistakes cannot be corrected and are likely to be repeated. Certainly, kindness needs to be used when relaying the information, but honesty is still the best option.

An individual that does not know what changes need to be made will never make any changes at all. As a result, the same mistakes will be repeated over and over again. The truth, in such a situation, may leave you disliked by the person, but it may also lead that person into the possibility of success. Sometimes being liked is simply not as important as being kindly honest. It is not always kind to deny the truth to a person who truly needs to hear it.

The next question: Are you being kind in telling someone the truth, or are you getting some type of power or pleasure personally by pointing out their failure?

To be a truly kind person, what you say must not be a reflection of your own insecurities or envy. The ethical person can take pleasure in other's happiness or successes. We seldom have control over what recognition we receive from others, but we do have complete control over how we react to the recognition others receive. Business owners especially need to consider how they treat individual employees. A chain store employed a regional manager who knew the name of every employee, including those who only worked part time. Every time he entered a store, he seemed to make a point of speaking directly to each employee on duty that day. By calling each person by name and acknowledging their presence, this manager undoubtedly increased production and added to the employee's happiness - such a small action, yet such a large benefit.

**Looking the Part**

In the business world and in sales especially, assertiveness is valued. It is hard to imagine a meek insurance sales person. It is generally that "take-charge" type of personality that is prized. We read books on how to dress for success. Red power ties must be worn; business suits in specific colors are sought.
In fact, few of us desire to have a salesperson, of any type, who has an inflated ego sitting at our dining room table trying to sell us something. While we may not be looking for meekness, we do appreciate humility. Do ethics also concern such personality traits as humility? If you were new to an agency and were unsure of what was proper, whom would you copy?

Personality types do not signify ethical conduct, of course. Any person can be very ethical just as any specific personality type is not always honest. In fact, con men are often very charming, which is how they become successful in stealing from others.

**Courtesy**

Respect is an ethical behavior element. Some people seem to be instinctively courteous, but chances are it is a habit they have purposely formed or carefully been taught in childhood. Courtesy is not linked to income, background, or schooling. Courtesy is a trait that is purposely developed. Those who practice courtesy simply wish to make others feel comfortable.

I can’t say that courteous people are also ethical people, but they are certainly more pleasant to be around. Of course, con artists may also be very courteous, but for different reasons. We are drawn to those who treat us well. We are more likely to treat them favorably in return. Considering this, it is surprising that more people do not practice simple courtesy.

We have all heard the saying, "It was the straw that broke the camel's back."

That means that there was a string of burdens, one of which finally made the entire situation unacceptable. Even in marriages, it is often the tiny problems that erupt into divorce proceedings while the larger differences are seldom addressed. The final "straw" is the sum total of the indignities that were endured day-in and day-out.

Simple words, such as "please" and "thank you," make mundane tasks seem more enjoyable. Many managers seem never to have learned how to say these simple common words. They somehow feel that their "power" will be diminished if they ask an employee to perform a task. These managers prefer to order their employees to do the work. In the end, those managers do not get the performance they could have by using simple courtesy.

**Mores**

*Mores* are those customs, which are enforced by social pressure. Mores are relative to culture. They are established by patterns of action to which the individual is expected to conform and from which deviation may bring disapproval and perhaps even punishment.
While these standards are considered to be a matter of ethics, they may vary from society to society.

The Thorndike Barnhart Comprehensive dictionary defines mores as:

**mores**, noun: traditional rules; customs; manners.

We stated previously that only behavior may be dictated, not ethics. The term mores works directly into this context. Mores are ethical standards that are enforced by social pressure. Groups of professional people create ethical standards to give their profession honor. These groups desire society's approval and they realize that there will always be those among us who will not voluntarily follow ethical procedures. As a result, mores are developed.

Many types of professions deal with knowledge that the average person simply would not have. Insurance is one of those professions. As a result, those individuals who seek out the professionals must rely upon their honesty and integrity. A feeling of ethical standards (which are enforced by social pressure) must exist. It was the potential for abuse of power and knowledge that provided rules of what is often called ethical standards. Sometimes ethics are written standards; sometimes they are merely understood. Often ethics, which have previously been "understood", become written laws when individuals do not follow preferred practices. At that point, pressure from society makes these "rules" into written laws or mandates.

Terrance is new to the insurance industry. Therefore, he eagerly accepted when Ralph offered to take him into the field so that Terrance could see how to generate a sale. At their first appointment, Terrance noticed that Ralph did not fully disclose a limited benefit that the client had directly asked about. When they were back in Ralph's car after the appointment, Terrance asked about it.

Terrance: "It was probably just an oversight, but you didn't tell Mr. Macky about the limitation on that benefit he asked about."

Ralph: "Look, do you want to make a living or not? No, it wasn't an oversight. By law, that is not something that I specifically must state. It's in the material I left him. It's his responsibility to read it all. If he doesn't, that's his problem. I'm not a baby-sitter, you know."

Even with the limited training Terrance had received, he knew that company policy mandated clients receive complete information by agents. Even when not legally obligated there is an ethical responsibility to provide full disclosure. Ethically, Terrance knew Ralph should have openly answered Mr. Macky's question. Of course, if it ever came up, it was likely that Ralph would claim he had done so.
If such a scenario repeated itself often enough and involved enough agents and consumers, it is likely that the state would then mandate specific legislation addressing the situation. Ethics, or mores, already mandate it. Every consumer wants complete honesty from those they deal with, including complete disclosure from their agents. Therefore, complete information is a custom, which is enforced by social pressure.

*Mores are established patterns of action to which an individual is expected to conform.*

Mores vary from culture to culture because how people live and what is important to them vary from culture to culture. For example, an insurance agent probably would not have many rules (resulting from society's pressure) in cultures that have no past experience with insurance. Since it has not been a part of their culture, the need for specific rules may not be known. As the need and desire for insurance increase, however, such codes of conduct would arise. We have seen this in our own country. When Medicare was first introduced, there were relatively few rules or regulations on the design of Medicare supplemental insurance policies. As abuses mounted, standards were implemented because the need for them brought about pressure from our society.

Mores relate to customs, not always laws, although those customs often develop into laws. Mores are customs that are enforced by social pressure. In this context, "right" simply means according to the mores and "wrong" means in violation of the mores.

We must point out that mores do not automatically make an action right or wrong. Mores make no attempt to determine what is right or wrong morally. They simply define what is right or wrong according to the given culture.

A good example of this has to do with the slavery that existed in the United States. It was the custom in some areas to own slaves. Those who lived with those customs generally tended to support slavery. That belief (which is a mores) did not necessarily make it morally correct. There is the tendency in any group of people to consider their best interests to be right. That which is contrary to their best interests may often be considered wrong. In some areas of society it could be argued that mores may be negative to one group of people and positive to another.

As a whole, however, mores tend to be the general rule of conduct for the society in its totality. Generally speaking, it is right for the members of the culture to follow the mores because they developed from the group in its entirety. Without mores, any society would lapse into a state of anarchy that would be intolerable for its members. While this basic concept is correct, one should not lose sight of the fact, however, that not all mores are morally acceptable. There is certainly some obligation to conformity in our society for the good of all. If one is deviating from the generally accepted code of behavior, that individual might wish to consider the possibility that his or her deviation has to do with personal gain. If this is the case, that deviation cannot be rationalized away.
When Helen Keller was asked if there were anything worse than being blind, she answered: “Yes. Being able to see and having no vision.”

It is a natural and correct human condition to want to be somebody! All of us need to receive recognition for who we are and what we do. Unfortunately, so often we do not have any idea what our calling in life is. We spend years in school, often years in a job which simply pays our bills. We may spend virtually no time at all determining what is important to us and what will give our life meaning. Again, it all comes back to the “why” in our lives and careers.

There is no denying that our workplace has a great influence over who we are. We are constantly exposed to the theories of sales techniques (some good, some bad), the promotions of numerous companies (sell our product and go to Spain!), of our agencies (Your production is down. What are you going to do about it?) and of our coworkers (I sold 10 applications last week. How did you do?). There is also an added pressure: since we work on commission with few companies offering any guaranteed salary, we know we must produce or our creditors may not get paid. The financial pressure itself can cause the most honest salesperson to be tempted to get a sale in any manner possible.

A work atmosphere that is kind and considerate, education oriented, and cooperative can go far in securing ethical behavior practices, but let's be realistic. When an agency is investing heavily in its sales force, it is likely that production is a major criterion for remaining employed there. Certainly there are agencies (many of them) that do promote both sales and ethics. If you are lucky enough to find yourself in such a work situation, it is likely that new comers become more ethical (just as others will become less ethical in the opposite type of atmosphere) just by being exposed to those who work there.

How does one know if an agency is a good place to work? We cannot give you any sure guidelines. It may be necessary to simply try the agency out for a month before it is possible to know. You can, however, ask yourself a few questions:

1. Is the agency anxious to equip you to succeed? In other words, do they have an ongoing educational program? This is not referring to the required education that your state demands, but rather to a program that connects you soundly with your products.

2. Does the interaction at the agency seem to be relaxed and positive?

3. Do you get a "gut" feeling that you will be happy there? We are often reluctant to consider whether or not a workplace will make us "happy." Somehow that suggests that we might be a bit "wimpy", but if you are not content with where you are employed, the chances are you will not perform well in the sales field or you will be tempted to act unethically in order to maintain your pride.
If you really want to be somebody, become the “somebody” that you really want to be. When your life is nearing its end, chances are you will not be considering how you could have made one more sale if only you had tried harder, or listened better. No, you will likely do what most people do: regret the things you did not take the time to do with your family, for your religion, or for personal enjoyment.

It has been said that, while we clamor for the recognition and respect of others, what we are really trying to achieve is the recognition and respect that we give to ourselves. We are not attempting to weigh the correctness of this, but it does seem to make sense. Perhaps each of us, when considering our ethical conduct, should imagine our own deaths, reflecting upon what would be important to us then. What acts would we be most proud of in our lives? What will stand out? It is doubtful that, when death comes, we will remember how many sales we made. It is more likely we will think of the people we know and love and how they will consider us when we have died. For those who really want to be somebody, they will have been successful if those they love and respect feel the same way about them.

We occasionally hear a motivational technique that seems to mask the real aim of the motivator. Perhaps you, too, have heard this one:

"It is important that you make lots of sales so that you can help others. If you do not have any money, you cannot give as you would like to your church, your family, or your friends. If you make lots of money, then you can donate to organizations that are important, maybe even get a plaque put up in your name. Don't feel guilty because you are financially successful! The only way that you can help others is to help yourself."

We would not have a problem with this motivational technique if ethical behavior were given some importance. Each time we have heard this approach there was a clear rationalization of getting sales, no matter what, because down the road you would be helping someone else. We thought it seemed like a new twist to the "Rob the rich to give to the poor" theory. The professional will not fall for this.

Certainly, we are not advocating that an agent pass up a sale. We are advocating that ethics must be a part of each and every sale. There simply is no reason not to act ethically. It is not a matter of either/or (either get the sale or be ethical). Ethics and selling simply go together, as many salespeople from all types of vocations can confirm.

As we have stated over and over, our actions speak louder than our words. Being an ethical person is our statement about ourselves. It is our statement to our children, spouses and our coworkers. Behaving in an ethical fashion, not just in our work but in our daily lives, is our declaration that we value who we are and what we do.

An ethical insurance agent that goes bankrupt because he or she could not bring in the earnings necessary to pay their bills is not likely to do the consumer much good.
Therefore, for the good of the consumer, it is not enough to merely be ethical. The agent must be both ethical and skilled in his or her trade. In fact, it seems probable that the financially successful agent is more likely to be ethical since there will be less stress involved, less desperation to make the sale.

**Education/Continuing Education**

Certainly education must play a role in ethical selling.

Why is education important? It is common to hear agents and agencies alike complain about the educational requirements of their state. The agent may look for the shortest or easiest educational course to simply get the requirements out of the way.

Consider this:

You are not feeling well so you go see your general practitioner. Your doctor states that you must go to a specialist because he or she suspects that you have a heart problem. The specialist that is recommended has a booming practice and obviously does very well financially. The office is plush and he or she drives into the complex parking lot in a fancy foreign sports car. There is lots of office staff and everyone seems intent on pleasing the waiting patients. Even so, you ask the medical specialist some questions that are important to you about their schooling.

The specialist replies, "Oh, don't worry yourself about that. I finished school twenty years ago, and I haven't had the time to attend any of the seminars or other educational programs. But don't let that worry you. I've had lots of practice and I make a point to read all the brochures sent to me by my suppliers."

Of course, we realize that a heart specialist is not an insurance agent. Even so, the point is the same. How much confidence would you have in such a doctor? Why should a consumer have confidence in an agent that does not consider education important?

Probably every agent alive has attended a seminar where educational laziness was obvious. Of course, it is the responsibility of the speaker to be interesting and cover a topic in an organized and practical fashion. Having stated that, it is also the responsibility of the agent to attend the seminar in a prepared manner. He or she should have a notebook, ink pen or pencil or a recorder. Notes may be optional, but if the seminar is truly educational it does seem that notes would be appropriate.

It is not appropriate for the attending agent to talk to those around him (which is likely to interfere with the enjoyment and learning of others), read the paper or a magazine, write personal letters, or work on personal business during the seminar. It is not unusual to observe an agent or two sleeping through the seminar waking up only long enough to
sign the roster that is passed around for attendance. Certainly, the agent who signs in and then leaves for an hour or two is not learning anything. Although most states have specific rules about such actions, they still occur. The agent who must be policed into being responsible about his or her educational actions cannot be considered ethical or even professional.

As an educational company, we have heard complaints from agents who feel they have been in the business too long to learn anything new. Again, we refer back to the medical doctor who feels education is not necessary for their continued medical practice. Just as you would not feel comfortable with such a doctor, would your clients feel comfortable with that attitude from you?

**Getting Education in a Timely Manner**

It is impossible to truly be a professional unless education is made a priority. Every educator's dream is to no longer hear "How easy are your courses?" It certainly does separate the serious career agent from the average agent.

Most states do now require that education be obtained. While there was initially great variation among the states, they are gradually becoming uniform due to the adoption of the Midwest Zone Agreement. States want uniformity in education and procedures to better monitor the industry. At all times, however, it is the responsibility of each agent to know and understand their state's education requirements. Each agency is responsible for promoting education as an important feature necessary for the welfare of both the agent and the consumer. An agency should never resent the time an agent takes out of the selling field to acquire education. In the end, the agency also benefits.

The words, "in a timely manner," seem to be a key phrase. It is very difficult to get all that is available out of a course if the agent must rush through it in order to meet a deadline. Education is the mark of a true professional.

What about getting education that is not required by the state? Some agents complete education, which gives them specific designations, such as Chartered Life Underwriter (CLU) or Registered Health Underwriter (RHU). These designations are the result of additional education specific to certain insurance lines. While such designations do not necessarily mean the agent is a wiser or a more skilled salesperson, they do show that the agent is serious about his or her profession. Regardless of the line of work a person is in, additional education is always a sign of a true professional. This is true of a teacher, a doctor, a lawyer, and certainly an insurance agent.

There is another side to education besides formal, credted courses.

Angie is a fairly new agent having only been in the sales field for about six months. She works for a large agency with a very large field staff. While the agency does hold
product meetings, it is not unusual for new items to be added before they have been formally introduced in the product meetings. As a result, Angie is often given brochures and applications for products she is not familiar with.

Angie's field manager, Reggie: “Angie, here are some brochures for a new cancer policy we just got in. It's fairly simple, but if you have any questions give me a call. Just read the brochure. That should do it.”

Angie reads the brochure and understands the basics of the product. What Angie is not sure about is where such a policy fits in and who might benefit from buying it. She knows that major medical policies are supposed to cover such things as cancer. Since Angie sells mostly life insurance, however, her understanding of medical policies is not great. Angie makes the determination that many plans must not cover cancer. Otherwise, why would insurers issue cancer policies? Angie sells two cancer policies in the first week and is highly praised by Reggie. Being so new, Angie does not often get praise, so now she begins to make a special point of suggesting her clients buy the cancer policy.

We are not trying to suggest that cancer policies are either good or bad. The question here does not necessarily concern the value of the policy itself, but rather how Angie handled a situation concerning education. Since Angie was not sure where this new product best fit in and misjudged major medical coverage benefits, what should she have done? It was obvious that Reggie felt the brochure should answer her questions, but he did offer his assistance if she wanted it.

What were Angie's options?

1. She could have called Reggie or cornered him at the office to ask questions.

2. She could have asked other agents more experienced than she.

3. Angie could have waited for the product meeting and asked questions.

4. Angie could have called the insurance company marketing the product. Most companies do have a product support department.

Did Angie need to do any of these things? Since she was able to sell the product even though she was not fully educated in medical policies, did any questions even need to be asked? Remember that Angie did not have a great understanding of medical policies and made the assumption that some plans must not cover cancer. Is it possible that she misrepresented existing medical policies due to her misunderstanding? We know that Angie would not have purposely misrepresented other policies, but does this lessen her liability? If Angie did misrepresent other plans, what will this do to her credibility if her clients discover her error? If Angie did not bother to explore this product completely, is it possible that this is a work pattern that repeats itself with other products also?
Does the agency bear any responsibility here? Although they do have product meetings occasionally, is it their responsibility to have such meetings before releasing a new product to their agents? Since the agents are basically self-employed, does this mean that education is solely the agent's responsibility and that anything the agency does is more of a courtesy than a responsibility?

We are not attempting to answer these questions. Often the answers vary so much depending upon such things as contracts, etc. that each agent must determine their own answers. However, it is certainly true that each agent must take on a degree of responsibility when it comes to education in general. To rely upon another person or agency to fulfill educational needs is foolish, both personally and financially.

**Laying Out Policy Benefits and Limitations**

Once the consumer has agreed to hear the agent's presentation the agent enters into many possible pitfalls. Policies can be very difficult to understand. Most presentations involve a few set items, which include premium rates, benefits, agent services and company stability. Of these, the premium amount should be the least important, although our clients do not always allow this to be so. As a result, rates often take up the majority of the presentation, yet an Errors and Omissions claim has never occurred due to the premium quoted. Probably 98 percent of the E&O claims filed relate to the benefits of the program and how those benefits were discussed (or not discussed, as the case may be). Obviously, more time needs to be devoted to that aspect. Then, as an agent, you must hope that the client remembers what was said and understands the concepts discussed.

The insurance contract can be very intimidating. Technical in nature, complex in its subject matter and seldom read in full by either the insurance agent or the policy-owner, it is bound to be misunderstood at some point by somebody. It has been said that insurance contracts are the *number one unread best seller*. More insurance contracts are probably sold than nearly any other type of contract, yet they are seldom read by the consumer. Unfortunately, policies are seldom read in their entirety by the selling agent either.

To our clients, the most important part of the policy is the part that begins, *"We promise to pay . . ."* In reality, all other parts are, of course, limitations and/or conditions on the policy.

In some ways, life insurance policies are more easily understood than other types. After all, a person is either dead or alive. If the insured dies while the policy is in force, the promise of a payment is kept. In a medical policy, there may be numerous limitations or conditions of payment that the consumer (policyholder) has difficulty understanding. Medical policies contain such things as co-payments, stop-loss provisions, elimination periods, plus a variety of other confusing and easily misunderstood clauses. All of the
provisions can create dissatisfaction, which can cause questions regarding an agent's diligence in presenting the policy and providing services. This is not to say that a life policy should not also be clearly explained to a client. Any contract can be confusing to the consumer. Any contract can cause a misunderstanding.

There are steps that an agent can follow to minimize possible misunderstandings:

1. **Full disclosure** is always necessary in any type of policy being suggested to a client. Where different interpretations are possible between a brochure and the actual policy, the policy is always the final authority. A brochure is simply a selling tool; never the final answer. The statement the agent receives over the telephone from the agency or home office also takes second place to the actual contract. The policy is the final word every time. *An agent who has not read the contracts he or she is selling, is an agent waiting for a lawsuit to happen.*

2. An agent should always be slow to replace an existing contract of any type. This is not to say that an existing contract should never be replaced. However, to do so without fully examining what is currently in place would be foolish. The agent should first be fully informed of any new or preexisting health conditions, takeover provisions and limitations that may exist in the new plan. Health problems of any dependents that may apply should also be reviewed.

3. Sometimes owners/employers may not be enrolled in and paying premiums for **worker's compensation coverage.** While this does not necessarily apply to the senior clients you will encounter, increasing numbers of older-age people are now working past the typical retirement ages and might need this consideration.

4. Whether you are dealing with a health program, a disability program, or a life insurance program, make sure that **health questions** are clearly understood and correctly answered. A term that has come into wide usage lately is **clean sheeting.** It means that an agent knowingly fails to correctly list existing or past health conditions of the applicant. The agent is presenting a "clean" application so that the company will accept it and issue a policy. This is obviously illegal and will not be tolerated by any insurance company!

5. Sometimes an agent simply is not aware of **existing health conditions.** If the applicant does not fully understand a health question, it may be incorrectly answered through no direct fault of the agent. We say direct fault because it is ultimately the responsibility of the agent to present the questionnaire in a way that is understandable. Even if the agent thought the health portion of the application was correctly completed, it will not alter the insurance company's view of it. A policy may be rescinded (taken back) by the insurance company for incorrect or undisclosed information. This may occur, for example, on a question, which asks if the applicant has high blood pressure. Since the person is taking a medication that keeps his or her blood pressure under control, they may answer the question "no" when, in fact, it should have been answered “yes.” Since these types of
misunderstandings can easily happen, an alert agent will want to closely monitor the questions and answers on applications.

6. Eligibility of applicants is always a concern when replacing an existing coverage. Do not overlook the eligibility of dependents also. An employee's spouse or disabled child may be especially vulnerable.

7. Any time an existing coverage is being replaced with a new policy, continuity must be considered. The old plan should never be dropped until the new plan is firmly in place. The policy should actually be in hand and reviewed for accuracy before the old policy is dropped.

The actual way in which a plan is presented can be very important since so many of the consumers will not understand industry terminology. The weight falls on the agent to present the policy in such a way that understanding is possible. Again, this often comes down to good communication skills. We also suggest that you pay close attention to the "body language" of your clients. It is often possible to tell that your client is lost merely by the expression on their face. Many people feel awkward saying that they are lost. This might especially be true if they feel their agent is in a hurry to get on to another appointment.

There are also those agents who cannot seem to resist being overly technical. The agent may feel that such technical explanations are necessary or he or she may simply be trying to impress the client. These agents may be extremely knowledgeable, but they are unable to present their knowledge in a way that is understandable to the layperson. While this relates more to skills than it does to ethics, an ethical person will put a priority on client understanding. If the agent is trying to impress the client, then we must ask the question, does ethical conduct allow for such self-serving purposes?

**Policy Replacement**

Most agents are geared to replace other policies, if necessary, to bring in business. Even the most ethical of agents realize that this will often be part of their sales day. In some areas of insurance, replacement became such a problem that state and federal legislation was enacted to protect the consumer.

Most states require that comparisons (for the purpose of replacement) be precise and done in a manner that fairly compares the two policies. Often there are specific forms, which must be utilized if replacement of an existing policy takes place.

Agents often complain that it is very difficult to compare policies if the types do not have much in common. It ends up comparing apples to oranges rather than apples to apples. Whatever the situation, an ethical agent will fairly compare the two products, not only because he or she is ethical, but also because it is simply smart to do so. We live in
a lawsuit prone society and it is not surprising that many consumers are all too willing to sue.

Most consumers are aware that competing agents will be attempting to replace each other's business. Realizing this, consumers do tend to use judgment before replacing their policies. Replacement practices may not be as obvious to the consumer when it involves an agent replacing their own policy. Consumers seldom question a replacement when it is the same agent (versus a competitor) doing the replacement.

**Why would an agent replace their own business?**

An agent may replace their own policy for several reasons; some make sense while others are questionable.

One reason some policies are replaced by the writing agent is to gain another commission or a higher commission, depending upon the type of product.

Another reason an agent might replace his or her own business has to do with the mobility of the industry. It is not unusual for agents to work for a period of time for one agency and then, for one reason or another, move on to a different agency. If an agent is not meeting production standards, the first agency might terminate the agent or terminate benefits, such as providing leads. When the agent moves on to another agency, he or she often feels that his or her clients belong to them. Legally, this may not be true, depending upon the agent's contract provisions with the agency. Regardless of the legal aspect, the agent may desire to bring his clients with him to the new agency. Since the agency is benefitting from the additional business, few agencies worry about the ethics of such replacement business. In fact, it is not unusual for agencies to actually encourage the practice.

A third reason for policy replacement deals with company stability. The industry has seen some ups and downs in the financial stability of some insurance companies. If an agent feels that he has clients in a company that may be suffering some financial problems, the agent may change their client's policy in an effort to protect the consumer. Certainly it is best to use strong companies initially to prevent this situation, but even the most careful agents may, at some point, find their clients with an unsound company.

Replacement of business is sometimes proposed by the agencies that have legal rights to the business but, due to contracts with vested agents, are paying part of the commissionable earnings to those terminated agents. The agencies may be able to move the business within their agencies and therefore, discontinue the commissions paid to those agents who have been terminated. As we have stated, not only individual agents, but agencies as well have a duty to behave in an ethical manner. Most insurance laws protect the consumers, not the agents.
When the Agent Allows Misconceptions

It would probably be surprising how many policies are sold on the basis of assumed facts or misconceptions. We are not saying agents purposely misled consumers, but they may have allowed misconceptions.

An agent relayed this story:
I was sitting in the home of an older client who was interested in investing in an annuity product. I was showing him several plans available. One was paying a higher interest rate than the other two, and the consumer liked the higher rate. I made a point of telling him the ratings of the companies, carefully pointing out the one company’s "B" rating.

After a moment's pause, he replied: "Hell, I would have been happy with B's when I was in school."

It is obvious that the consumer did not understand the importance of financial ratings. It would have been easy to simply fill out the application and never address the obvious misconception on the part of the client.

Any agent who has spent time in the field can probably tell their own stories of people who made incorrect assumptions placing a sale directly into the lap of the agent. Some misconceptions may simply be amusing, while others may cause serious legal problems. Sometimes it can be so difficult to clear up a false assumption that the agent simply lets it slide by. This is seldom wise. It is always better for the client to correctly understand what they are buying. The next agent in their home may clear up the matter, making the first agent appear either inept or unethical. As one agent relayed, he hates coming into a home where he must spend most of his time correcting the false information left by the agent before him. While this does tend to cement the sale, it is also a waste of time and energy for the second agent on the scene.

One other point should be made at this time. Insurance agents tend to have a reputation only slightly higher than that of a politician. Why does this happen? It is probably safe to say that the majority of this reputation comes from consumers who feel that they were "taken" by an insurance salesman. Either the consumer did not get what they thought they were buying or they felt pressured into buying something they did not really want or intend to buy. We often hear people say that the "big print giveth and the small print taketh away." In reality, print size is generally mandated by each state. There is no "big" or "small" print. What the consumer really means is that claims were not paid due to policy limitations or gatekeepers. A policyholder that knows a specific claim will not be paid is not likely to be upset, but a policyholder that thought a specific claim would be paid will be most upset when he or she is turned down for the claim. That policyholder will probably feel the salesperson misled them or, at the very least, failed to fully disclose the conditions and limitations present in the policy.
When the Premiums Seem too High to the Client

Another area of ethical behavior that should never happen still needs to be addressed. It needs to be addressed because it does happen. There was the client who thought he was paying the premium for a full year only to discover that it was a 6-month premium. There was the woman who was told her bank would be drafted one amount only to learn that the draft was for a much higher figure.

Sometimes when an agent fears he or she is losing a sale due to the amount of the premium, figures may be incorrectly stated for the benefit of the sale. We would like to think that such situations are merely misunderstandings, and certainly misunderstandings may happen. There is never any excuse for purposely misstating premium amounts.

Premium amounts may be misstated simply because the agent is inexperienced in using premium tables. So many types of policies have formulas for figuring rates. For example, many long-term nursing home policies have premium rates that vary according to multiple factors, each of which must be considered. Major medical plans are based upon ages, the plan selected, and sometimes health conditions.

Obtaining Proper Application Signatures

The practice of forging client signatures is not only unethical, but illegal as well. Despite this fact, it is much more common than many people might realize.

There are many reasons why signatures may not be obtained from the client. Often, it is merely an oversight by the agent. Such oversights clearly suggest disorganization on the part of the agent. New agents might benefit from highlighting signature lines on all their forms before entering the field. Doing so could prevent the omission of needed signatures.

In some cases, signatures might be purposely overlooked as a way of avoiding the explanation of certain forms. This commonly occurs when replacement forms are required and the agent feels inadequate explaining the information contained in them. Again this is not only unethical, but generally illegal as well since all forms need to be disclosed to the client. In addition, the well-trained, well-organized agent simply does not need to omit signatures, whether by oversight or by intention. Anytime an agent feels uncomfortable about a particular form, he or she should seek council from an experienced ethical agent.

Keeping in Touch after the Sale

The hardest policies to replace are those belonging to the agent that keeps in touch with his or her clients. What are an agent's ethical duties regarding service following the sale?
This often depends partly upon the arrangements made between the agent and his or her agency or insurance company. Some companies have a separate servicing staff so that the selling agent is not expected to do any further service work. Most agents, however, are probably expected to do any necessary service work personally. Even if the selling agent is not expected to do so, most professionals do feel that referrals and additional sales result from close client contact. In addition to that aspect, everyone likes to feel that they were more than a commission to a salesperson. Even a simple birthday card at the appropriate time is appreciated by the consumer.

Many agents want to provide service to their clients. Not all agents or agencies feel this desire. Many simply do not wish to take on the burden of service after the sale. Certainly, servicing one's clients is prudent, but is it required from an ethical standpoint? Some states mandate that each client must have an assigned agent. This means that the insurance company must assign an agent to every account if the writing agent is no longer with them. Those states then expect those assigned agents to handle any claim requests that might occur. Many of the states report that the lack of claim service is the number one complaint from consumers.

Earlier in this text we pointed out that it is only possible to mandate behavior, but not necessarily ethics. Is it possible to force an agent to properly service their clients? Probably not. If the agent is not smart enough to understand that service promotes sales and helps business retention, it is unlikely that he or she will be smart enough to understand service requirements imposed by his or her state. In fact, an agent who is unwilling to service his or her accounts, probably will not even be educated enough to know how to service the accounts. When this happens, one can only hope that the insurance company or agency will step in and handle the matter. If no one handles it, eventually the client will simply change agents and insurance companies.

**Selling the “Fast Buck” Items**

Some might consider “fast-buck” an unfair label. However, we feel the evidence is compelling that many people, not just insurance agents, will quickly step forward if there appears to be a "fast buck" available by selling a particular item. There may be differing opinions on what constitutes a "fast buck" item. *In fact, it is often true that the fast buck lies not in the item sold, but in the manner in which it is sold.*

In some states, selling Revocable Living Trusts has become big business. While there is no doubt that a living trust can be very beneficial in the proper circumstances, many of these trusts have been sold for inflated prices to people who did not benefit in any way. Sometimes the consumers did not benefit because the trust was not properly executed; sometimes the consumer simply did not need the trust, so their purchase was unnecessary.
Perhaps the most perplexing aspect of the sale of these revocable trusts has to do with
the way in which they are sold. An item is definitely a “fast buck” item when the seller
says anything necessary to get the sale. Consumers have been told so many incorrect
things about trusts that it has become clear to many state regulators that the aim of many
trust companies is simply to bring in cash. If this were not the case, there would be more
control exercised over the sales force. Unfortunately for those who are honest in their
promotion of revocable living trusts, many states have passed specific legislation in an
attempt to curb the abuses.

The “fast buck” label does not intend to imply that particular items are in this category.
Actually, it has to do with how the items are sold. Any product paying a commission or
finder's fee can become a fast buck item. Fast buck has to do with the attitude of the
salesperson. Is the salesperson thinking almost entirely about making some fast money
or are they considering where the item fits and whom it best serves?

As we saw with the living trust sales, a valuable estate planning tool was misused by
salespeople for the sake of making a fast buck. There was often little concern for the
consumer or the consumer's needs. Therefore, this item is both a useful vehicle in the
right circumstances and a fast buck item in the wrong circumstances.

**Commingling Funds**

Any professional should always be shocked when they hear an agent express ignorance
regarding the hazards of commingling funds. This is something that every agent should
be aware of. While state laws do vary, the basic concept remains the same: insurance
funds and personal funds should never be mixed. By this, we mean that two separate
accounts must be kept. It might even be wise to go a step further and use two separate
banks, one for your personal account and one for your insurance account. Many
professionals have an operating account and a trust account. The trust account is used for
funds that generally belong to the insurance company or the client – not to the insurance
producer. The operating account is used for commissions that are due and payable to
either the agent or the agency. The operating account is used to pay the routine bills that
come with running a business. The trust account holds funds "in trust" for either the
insurance company or the policyholder.

Any agent that is not clear on this should contact their state's insurance department for
that state's specific requirements.

**The Professional**

There are many people wanting to be thought of as a professional investment advisor.
Simply desiring the title does not make one a professional, however. In many states, a
person can give themselves nearly any title they desire. The title may have nothing at all
to do with either experience or training. From a business standpoint, it means selecting
insurance companies, products, and other support systems that are both professional and knowledgeable.

The first step for any ethical investor or advisor is to be sure that the insurance companies and professionals giving advice are themselves ethical. That does not necessarily mean that they must share the same views on the environment, government or community. It does mean that they must be honest in every capacity. Certainly, this means following all laws, but also honest in how they deal with the consumers, agents and brokerages.

Consumers often ask others for recommendations. Professionals in other fields that are themselves ethical often make referrals as well. These professionals would include accountants, bankers, or attorneys. It may even include fellow insurance agents that do not themselves handle particular types of investments. If you belong to a specific type of organization and your investing goals are in line with that organization's views or activities, other members might also be an excellent referral source. For example, if you were part of a group that worked with homeless people, fellow volunteers are likely to have your same goals. As a result, they might be able to steer friends to you for professional investment advice. Ethical investors do generally feel more comfortable when their investment advisor is like-minded.

Another area often overlooked is fellow church members. If you have members of your particular religious organization who work in the investment field, they may be an excellent source of information. Consumers do not always feel comfortable working with someone they feel TOO close to, but they may still consider you for their ethical investments in some areas. In addition, it may not be wise to take on clients that are close friends or relatives. There can be many pitfalls when clients are more than business associates.

**Preparing for Tomorrow**

We hear it so often, but our lack of preparing financially for retirement is a huge problem in America. It is actually an ethical duty to financially prepare; otherwise we are expecting others to support us financially in retirement. Those “others” may be our children and grandchildren or the taxpayers, but whoever it ends up being it is the duty of each person to do what is necessary to be self-supporting. It is not ethical to spend every dime today without consideration of financial needs in the future.

**Fixed and Variable Income**

Income vehicles fall into two categories: fixed, and variable.
Fixed income vehicles never vary the amount of income they pay. These include some insurance products such as annuitized annuities. They also include such things as bonds and commercial paper.

As the name implies, variable income vehicles vary. In other words, such vehicles do not produce a "set" amount of regular income, but rather will go up and down according to several regulating factors.

Investing for retirement income is usually a process that happens over one’s working career; the individual routinely sets aside some amount into a fund that produces earnings. Both principle and interest are invested with retirement in mind.

Financial Management

Each of us must manage our day-to-day lives in the best way we can. This includes the management of our finances. This is just as true for the insurance agent as it is for any other person in any other line of work. In some ways, it is especially necessary for those in commissioned sales.

Those in commissioned sales often tend to overlook necessary financial discipline regarding taxes, Social Security payments, and other types of business requirements. As every agent has heard, there is a very high failure rate in commissioned sales. Some of those failures result not from a lack of sales ability, but rather from a lack of business sense. Most experienced businessmen and women state that their most important asset is their CPA or bookkeeper. Those who have an accountant who is experienced in small business or commissioned sales state they are especially happy with the relationship.

Sometimes it is difficult to locate those people and institutions one wishes to do business with. Generally, it is worth the time it takes to find them, however.

Most of us tend to bank with the institution located nearest us. Few people take any time at all in selecting their bank past the location. This is unfortunate since banks do vary in many areas. For the small business owner or independent agent, it is particularly necessary to understand the opportunities, or lack of them, offered by their bank.

Business ethics involves many things. Certainly one ethical concept is paying bills on time. This is true even in our private lives, of course, but it is especially necessary for your business. Not only may the person you owe money to be a potential policyholder, but they may also personally know other clients you currently have. An insurance agent with a bad financial reputation is not going to generate great trust.

Small business owners often overlook one other vital factor in their business: the people they hire. This includes not only insurance agents but also the office personnel. It goes without saying that anyone who answers the phone needs to be courteous. Beyond that,
personnel also need to be knowledgeable and display a willing attitude. Probably everyone has, at one time or another, been in a public setting where the person waiting on them obviously was not interested in the duties at hand. Perhaps it was a rude clerk in a grocery store or a clerk who seemed resentful when you requested a larger size in a piece of clothing. Whatever the incident, such actions always hurt the business they work for. For example, if a clerk in ABC store is rude, the customer does not say: "A clerk named Sue was rude." Rather she states "ABC store is rude."

Nowhere is this truer than in a commissioned business. A commissioned business typically has a great deal of competition. The consumer has many choices of companies and products from which to buy. An insurance agent who seems impatient for the signature or appears rude when a consumer does not wish to purchase a product damages the agency they work for. Chances are the consumer will not remember the individual's name, but they will remember the company that was represented. It only takes one unprofessional agent in your company to turn numerous sales over to your competition. Any agency who tolerates such behavior, no matter how much that particular agent sells, will experience reduced business overall.

Due Diligence

What does the term, due diligence, actually mean? For the agent, due diligence is the analysis of a particular company's products, performance and financial standing. Where life insurance is concerned, this is often done to determine whether or not there is a reasonable expectation that the illustrated values presented can actually be achieved. Life insurance is, in some measure, the business of making long-term promises to clients. It is vital to those clients that the company is able to keep the promises they are making. Due diligence is the agent's analysis of whether or not the company can, in fact, keep their promises. The term, due diligence, is primarily derived from the securities industry.

For the insurance company, due diligence is an ongoing process which insures that pricing objectives are being realized, and that integrity and consistency of internal procedures are being maintained. It is working with the agents and agencies, as well as their policyholders, to preserve fairness in all parts of the operation. An insurance company that is concerned with due diligence will treat its sales force and back-up members as well as they treat their policyholders. Company due diligence also means making investments that are sound and prudent. For life insurance companies, due diligence is not a new concept, even though it may be for many agents.

The life insurance industry has moved their product design away from fully guaranteed values and benefits towards a dependency on current, sometimes more favorable parameters. This means more risk has been transferred to the consumers. The factors more often used these days also tend to be more volatile. In many cases, only the strength and the integrity of the company involved can ensure that projected, non-guaranteed elements of the policy are actually realistic.
As agents and the general public have become more educated on the variety of options available, insurance has seen a change in how it is perceived. While price has always been considered, additional elements are now commonly looked at as well. Consumers want to know if the company they are considering can manage its overhead expenses, mortality expenses and investment returns in a way that allows the company to make good on its promises in the contract.

In addition, the role of the agent has changed. Whereas the agent was typically thought of as only the salesperson, consumers now consider the agent to be someone who must give reliable information for the good of the policyholder. We no longer accept the view that the agent represents only the company. This change in the general perception of an insurance agent places greater responsibility, both legal and ethical, on the insurance producer.

In the public's view, the level of service and the quality of the advice given are linked directly to the insurance company and that company's performance. It must be noted that practicing due diligence makes sense from many standpoints, one of which is financial protection for the agent, as well as the consumer. When an agent takes the time to investigate his companies (and document that investigation), he or she is also protecting their own financial future. Lawsuits are common and it is reasonable to believe that even a good agent can experience one. Due diligence is, of course, an ongoing process since companies can and do change how they operate. Due diligence might be considered as a method of self-protection through knowledge.

Many agents groan when due diligence is brought up. They picture hours of work put into a schedule that is already difficult. It should brighten their day to know that there are more answers than one might imagine at their local library. A morning spent looking up the companies they are representing, or are considering, is a morning well spent. There are three reasons to do so:

- To prevent lawsuits from angry consumers who feel they have been taken,
- To protect the trust they have spent hours building up with their clientele, and
- To determine if the people associated with the companies they sell have the level of integrity desired.

If an agent bases his or her company affiliations on commission levels, leads provided, or where the next convention will be held, he or she is in for a few surprises down the road. An agent should request a copy of the insurer's annual statement and pay particular attention to the interrogatories, because they are brief and speak to short-term changes from the previous report.

An agent needs to begin his due diligence process by gathering information on the major components of the company from as many sources as possible. This would include
seeking information directly from the company. In fact, this is probably the first place to seek information. Generally, such information is readily available. The agent should not overlook another simple way to gather information: ask questions. Management, fellow agents, insurance company staff, anyone who seems knowledgeable may be able to supply information. Anytime an insurance company seems reluctant to provide information to their own agents, a red flag should go up.

Insurance producers can learn much from simply asking other agents who have been with the insurance company for a relatively long period of time. Ask about the speed of the company's claim service since this is often an indicator of company solvency. Find out if commission checks seem to be consistent, correct and on time. If a financial error is made, how long does the company take to correct it?

The agent should collect the three most recent sets of financial statements and study them. Does the company seem to be making excessive profits? Does the company seem to be making minimal profits or perhaps too little profit to ensure continuance? Compare the surplus in relation to the amount of business being produced. Ask the state Insurance Department to see if there are any watches or cautions outstanding. How many complaints from consumers has the company experienced in the past year? You may also wish to look at complaints over a three-year period to see if any pattern seems apparent. The agent may also want to watch for any shifts in management of the company since this can change the philosophy of the company.

Once a measure of information is gathered, the agent must assimilate it in a manner that is easily understood and assessed. There are several ways to assess this information, but often the agent simply looks at it from the standpoint of "Does it feel right?" With so many carriers to choose from, there is no need to represent any carrier that does not feel comfortable.

At the very least, agents should consult rating agencies. They are not infallible but they will supply basic information. Only top rated insurers should be used.

**Technical Approach or Common Sense Approach?**

So many areas of ethical behavior are overlooked; one area that should not be overlooked deals with due diligence. Professional agents prefer to deal only with financially sound companies, but many agents may not know how to locate them.

There is both a technical way of locating sound financial companies and a common sense approach to it. Understandably, it is difficult for an agent to research each individual company, although that must be done to a certain degree. Sometimes, a common sense approach actually works better because much of the information that an agent may find on any given company could be outdated or unconfirmed.
A certain amount of technical analysis of historical data is important, especially as a point of reference to start with. To spot a potential problem before it happens, however, a common sense approach is often more effective. Once a potential problem is identified, technical analysis is then appropriate again. The technical analysis will either confirm or deny the suspicion of a financial problem within the company.

Financial due diligence could also be called solvency appraisal. Traditionally, such an appraisal is done from a technical standpoint. It is true that if you told another agent that you simply had a "gut feeling" that a company is having financial trouble you are not likely to be taken seriously. As a result, even if it is simply a gut feeling, you must be prepared to then proceed to the technical detective work that is necessary to validate your feelings. Many "gut feelings" originate from sensing that something has changed or is amiss. This might be something as simple as delayed claim payments. There are some problems or limitations to the technical approach:

1. Agents rarely conduct their own technical analysis. Instead, they refer to what others have compiled. It would simply be too time consuming to personally research each company we deal with and most agents are not willing to spend the amount of time it would require. In addition, few agents would even know where to begin such an analysis.

2. Most professionals feel that a true technical analysis requires historical data on the company in question. In the past such data was considered important, but with so many rapid changes occurring, the validity of such data may now be questioned.

3. Even though we do recommend that agents stay with "A" rated companies, there is evidence that the rating services are generally unreliable when it comes to predicting insolvencies. This appears to be true of both corporate bond rating services and insurance rating services. Many professionals find it best to review multiple rating companies so that several perspectives can be seen.

4. One problem with technical analysis lies in the oversimplification of only a few indicators. Agents and consumers alike tend to lock in on only one element in the analysis. The public, for example, knows only about the rating systems and seldom understands precisely what those ratings really indicate.

5. Generally speaking, the management of a company determines its business practices. If the company is not a mutual company, who owns it becomes an important indicator. If the owners of the company are not the managers, then who is managing the company is also very important. Corporate values and culture can often be shaped by a single powerful person. Along this line, if the management of a company changes, the strength and weakness of that company can also change.

6. Product design is something that agents often do spot immediately, especially if the agent is experienced. Product design tends to be a mirror of those who are
running the company. It is a fundamental extension of the leader's vision, desires, and values. Are there gimmicks or sound benefits within the product? Some products seem to utilize a "bait and switch" sort of theory. Common sense should also tell us that a product that puts out more than it takes in will not benefit the companies or its policy-owners.

7. As we have discussed, replacement selling is more common than ever before. As a result, the risk of adverse news or competitive interest rates can cause disloyal policyholders. This makes distribution a point of common sense. A debt loaded volatile national and world economy does nothing to reduce the risk that could pull a company into insolvency. Distribution of products must, therefore, be considered. Stockbrokers are notorious for rolling their money quickly. If a company does a lot of single premium or asset intense products (such as annuities) distribution can become critical. Insolvency risk is much higher when insurance products are distributed through a limited number of non-insurance distributors.

To recap, the technical approach has some limitations:

1. Technical analysis is difficult and few agents know how to do it.
2. Historical data is not always reliable.
3. Rating services are useful, but not necessarily an indicator of insolvencies.
4. Technical data is often oversimplified or simply misunderstood by both the agent and the consumer.
5. The ownership and management of companies that are not mutual companies is an indicator of company practices. Few agents or consumers personally know who is in charge of the companies they deal with.
6. Product design is a fundamental extension of the company's management, but technical analysis seldom takes this into consideration.
7. Distribution is critical for the solvency of a company, but it is very difficult to know how products are distributed in many technical analyses.

Despite these limitations, technical analysis is still useful as long as it is combined with the agent's common sense. There are many ways that an insurance company can get into trouble. Usually it is a combination of problems; seldom one problem alone. Instead of making little mistakes, the company might make one or more large mistakes, which of course can have severe consequences. Perhaps losses greatly exceed gains and capital and surplus are consumed. When money goes out faster than it comes in, no business or individual can run efficiently. This is called a negative cash flow. A positive cash flow means more money is coming in than is going out. In addition, if one or more of these
problems is made public, policyholders may begin to withdraw their money, which only intensifies the existing problems.

The old saying, *if something looks too good to be true, it probably is*, is a good common sense approach to insurance, as with so many things. The easiest product to sell may well be the very product you should avoid. It will save you future embarrassment and liability to avoid some products.

A common sense approach to due diligence is a practical way for many agents to spot potential trouble for themselves and their policyholders. The object is not necessarily to find those companies that are sound, but rather to avoid those companies that are not. Such things as ratings and historical data certainly do have their value, but they should not be the only indicators used.

The insurance industry has suffered many image problems, a few of them deserved. In public opinion polls, insurance agents routinely end up at the bottom of the list between attorneys and politicians. Consumers simply do not feel that insurance companies and their representatives consider ethics to be a high priority. In fact, many consumers feel that ethical behavior of any kind in the insurance industry exists only because the states mandate it.

For many questions of ethical behavior, there must be consideration of all facts involved since the deciding factor can vary from situation to situation. An agent must ethically give the insurance company all facts considering the insured that are pertinent to the issuance of the policy, but on the other hand, the agent also owes it to his or her client to give them all the pertinent facts regarding the insurance company. In other words, the agent has an ethical duty to *both* the insurance company and the policyholder.

In the past, most agents felt that giving the financial rating assigned to a company by a rating firm was sufficient, but in recent years that has not proven effective. In one case, it may be sufficient, but in another it may not be enough. How is an agent to know when he has given enough information or too little? Must the consumer take more responsibility for looking up facts and figures on a specific company or is that the role of the insurance agent and his or her agency?

Some people feel commission structures have been a primary cause for ethical problems within the insurance industry. These individuals feel a commissioned basis fosters an "anything goes" attitude. That does not completely explain the problem, however, since many other industries also function on a commission basis without the negative image that has plagued the insurance industry. Most experts feel that commissioned sales, of any type, is ethically neutral although it is possible to have unintended results if it is not structured properly. It is not the commission pay system itself that causes problems. Rather, it is how people prioritize their work and their lives that bring out negative
results. When making sales becomes the priority, without any other aspects considered, integrity can certainly suffer.

All companies want to make a profit. In fact, companies have a duty to their stockholders to run a profitable business. Being profitable, however, should not alter other ethical concepts within the business.

Property and casualty lines may have little incentive to use one company over another on the basis of commissions, since they tend to pay about the same. It is more likely to be an issue in the life and health field. Some advocacy groups are calling for the discontinuance of all commissioned sales people. Interestingly, few of the consumers themselves seem to view commissions as the root of the problem. Consumers are more likely to target the insurance company itself as the major source of dissatisfaction. Groups that are calling for the discontinuance of the commissioned agent force may not be taking into consideration the matter of customer service. While there are certainly a measure of agents and agencies that do not provide service, there are many that do. Without commissions, it is unlikely that service will get better. We have seen many industries that do not utilize commissions demonstrating very poor customer service practices. Many feel commissions may encourage good customer service since agents want to retain their client base.

A basic question asked not only by the consumer, but by the agents themselves, is whether or not the insurance companies and management staffs actually value ethical behavior in their field force. While most people do feel that practicing good ethics is also practicing good business, many agents feel that there is little, if any, recognition for ethical behavior or practices. Insurance agencies seem uncertain how to reward, or even recognize, ethical sales practices in their field agents. Certainly, underwriters value ethical behavior because it is necessary in order for them to underwrite the policies effectively. When an agent has a reputation for giving solid information, the underwriters are likely to do a better job for that agent in terms of time and judgments. On the other hand, when underwriters know an agent consistently omits needed information or is vague in the routine information given, then underwriters are much more likely to question every aspect of that agent's submitted applications. Certainly, in this area, ethical behavior is rewarded.

Clearly, the issuance of insurance policies is based upon ethical behavior. There is the general agreement that the insurance industry is founded on ethics. It would be impossible for the industry to operate without it. The risk-sharing mechanism is closely dependent upon the ethics of trust. The insurance industry depends upon the consumer to act ethically when disclosing personal information, it depends upon the agent to relay that information correctly to the underwriters and it depends upon the insurer to keep their promises that appear in the contracts. Even the claims that are submitted to the insurance companies depend to a certain degree on ethical behavior. Of course, we all know that many fraudulent claims are submitted each year, which drives up our costs for insurance
Dollars and Sense

Chapter 8: Sensible Ethics

protection. Such fraudulent claims are certainly unethical. Ironically, many consumers feel insurance companies have lots of money, which makes filing false claims, in their minds, acceptable.

There was agreement from those participating in the ethical review for Insurance Review magazine that encouraging ethical behavior, within any company, must begin with top management. A strong, understandable code of ethics must not only be a written doctrine, but also practiced by those at the top. The more massive a company is, the more a written code of ethics is needed since many of the employees may never have access to top management. When ethical codes are clearly stated and demonstrated by a company, the lower management and staff are more likely to behave ethically themselves because they know it is expected.

A written code of ethics that is buried in a company manual, but seldom discussed, is not likely to be taken seriously by the employees of the company. This is especially true when management does not appear ethical themselves. Employees certainly want to be recognized, so it simply makes sense for management to recognize ethical behavior. Such recognition will promote ethical behavior among the employees, which will benefit the company itself. On the other hand, if top management seems only to recognize sales without any concern as to how they are achieved, the message will be clear to the sales staff.

Some companies conduct ethics training sessions. Questions that arise in the sales field every day are looked at for possible solutions, which are both ethical and sensible. Ethical competency often is simply a matter of education. It is also a matter of peer pressure. When coworkers expect ethical competency, others are more likely to act ethically competent. Ethics must be made a part of the decision making both by the company management and individually by the personnel. If employees are to act ethically, however, they must feel confident that their superiors will stand behind them.

It seems like the quantity of rules and regulations grows daily. With their abundance, it may seem asking “is it legal?” should be enough. Simply following the laws may be the minimum acceptable level of ethical conduct however. It is up to the business organization to develop company standards for employees and sales staff. Ideally, that will be higher than is actually mandated by law. Of course, each individual must also set their own personal standards of conduct. We all know of individuals who do simply use what is legal as their standard of ethical behavior. For these individuals, as long as they are not breaking the law, any behavior is deemed acceptable, regardless of how many other people are taken advantage of.

Doing the proper thing ethically is simple when the choices are clearly between an action that is right or wrong. Stealing or not stealing is basically a clear-cut choice, for example. Making ethical choices is not so easy when the decision is between two sets of action, either of which might be right and/or wrong. This generally has to do with two
sets of ethics, either one of which could be valid. For example, we have all probably lied to someone in order to spare feelings. This may not necessarily make the action right, but the choice was made between truthfulness and another person's feelings. Both of those choices may be ethical (it is not right to lie nor is it right to hurt another person).

Ethical behavior tends to have long-range (versus short range) benefits. In the short term, it is often advantageous financially to make the sale no matter what tactics are used. In the long term it is more advantageous to behave ethically even if that means forgoing the sale. When an individual is financially stressed, it is more likely that he or she will ignore the ethical requirements making the financial gain the top priority. This applies to both individuals and businesses. When an agency or other type of business is struggling, their first concern may be profits rather than ethics. That is why salespeople must use some thought regarding whom they choose to work for.

Society as a whole has become much more demanding when it comes to ethical behavior. At the same time, we are living in an age when financial success is more likely to be admired. Often, we feel that others wish to be treated ethically, but others are not necessarily willing to do the same in return. Nearly everyone has, at one time or another, gone out of their way to do something for another only to be treated badly in return. Such situations do not change what is ethical but it may change our future behavior.

Sometimes ethical behavior is aided by our advancing technology. People may act more ethically simply because they realize that their chances of being caught in unethical actions are greater today than in the past. In the past, our technology often did not allow vital information to be brought out quickly. Today, with the aid of computers, information is much more available to a greater number of people. This brings up another question: when an individual acts ethically, not out of desire, but because they know they must, is that person actually ethical? As we previously pointed out, sometimes we are only able to dictate a person's behavior, not their ethical standards.

Each of us has a public image, which is either good or bad. We sometimes make the mistake of believing only large companies must be concerned with public relations. It is doubtful that any other area is more important than how the public (consumers) see us. Having a good public image means more referrals will be generated, more business will stay on the books and people will be more trusting of our advice. In fact, when businesses sell, it is often the public image of the company's name that raises the price. When a business has a reputation for excellent service or products, the business is simply worth more money.

We sometimes think of public images as having to do with advertising budgets and promotion. Actually, our public image is simply how others perceive us. The definition of oneself is seldom set down by us, but rather by others we come in contact with. We establish the traits others judge us by. This is true of both individuals and business.
Individual ethics and business ethics are sometimes thought to be different things, but that is not necessarily true. Every business has a responsibility to develop a business ethic. Certainly, an insurance entity must worry about becoming the concern of a government regulator if legal ethics are not followed, but it really goes beyond that. Without clear principles within the business outlining what is acceptable and what is not, problems may easily develop, with both the public image and the legal continuance.

Accounting firms and attorneys point out the need for a clearly written, legally sound employee manual for every business. With the number of employee-related lawsuits being filed, employers simply cannot afford to ignore the need for a well thought out employee manual.

Experts note that a significant percentage of these employee-based lawsuits would never have stood up in court if the situation had been properly addressed in the manual and then emphasized at company meetings. Businesses that have not put together such a manual are definitely at legal risk. Besides lessening the likelihood of being sued, a well-written (and followed) company manual can also improve employee morale as well since it establishes what is expected of the employees.

Such things as churning policies, misrepresentations of products or services, and outright fraud taint the public's image of our industry, which ends up hurting every person within it. All of these issues need to be addressed in the company manual. Often, salespeople are hired as independent contractors. In other words, each salesperson is self-employed. An agency may do this for a number of reasons, but even if this is the situation, the agency would still be wise to formalize a manual on ethics in selling. It is simply prudent to do so.

**Selecting Insurers to Represent**

It is common for an agent to go to work for an agency and simply accept whatever companies and products are given them to work with. While we would like to assume that an agency has done their homework, this may not always be the case. In addition, it is possible that the agency viewed the companies and products only from a profit point of view.

What responsibilities actually fall on the selling agent? The answer varies depending upon the individual’s view. As little as ten years ago, due diligence was something done by broker-dealers, people selling securities and by some home offices. Seldom was due diligence thought to be an agent's responsibility.

In more recent times, agents are being told that due diligence is their responsibility. This statement is often the result of court actions. In other words, it is now being legally determined that individual agents are responsible for the recommendations they give, the products they sell, and the companies they represent.
If It’s Legal . . .

Another philosophy often heard expressed is: *If it's legal, it must be moral.* Again, we only have to look at our country's past history to know that this is not necessarily true. The fact that slavery was, in some places, legal did not make it right. The fact that children could legally work in factories did not make it right. The fact that it was illegal for women to vote and sometimes even illegal to own property independently of her husband did not make it morally right. While laws are intended to have a strong connection to morality, we know that this is not always the case.

It is certainly necessary to teach our children to respect the law. It is necessary to not only respect the law, but in most cases, follow it as well. Otherwise, our country could not prosper. However, not every law reflects what is moral. As Martin Luther King, Jr. said, "Any law that uplifts human personality is just. Any law that degrades human personality is unjust."

Moral inconsistency appears to be a part of our human nature. Even good people will be tempted in some situations. Morals are often about dealing with the temptations of life. It is easy to be ethical when temptations never arise; the real test is resisting the temptations.

Ethics often require tough choices but ultimately our lives are usually easier. Choices between right and wrong are not always easy to identify. Individuals must make what they perceive to be the best choice. It is not necessary to always be right but it is necessary to stay with the morals we believe in.

A moral *dilemma* is the struggle to determine what is right, while a *conflict* occurs when you know what is right, but you do not particularly wish to do the right thing. For example, among friends, relatives or colleagues it can be difficult to take an unpopular stand even if you feel strongly on the issue. Interestingly, studies have shown that individuals are more likely to take a stand on political issues than on morality issues. Perhaps it is socially acceptable to disagree on politics but not on moral conflicts.

Some people can react morally even in crowds, while others find it difficult to step forward. People who step forward in difficult situations possess *moral certainty*. They strongly believe in doing what is perceived to be right, even when others fail to act. It does not necessarily make their view right or wrong but these individuals are certain of their moral path. Such people are more likely to help a stranger in distress, even facing personal danger to do so.

Two separate studies have shown that a strict religious upbringing substantially contributes to a person's moral certainty. This may be because there is no ambiguity about what is right or wrong. There are straightforward definitions of right and wrong; good and bad. Another study revealed that when a person is presented with multiple
choices or ideas of what is right or wrong, the more likely that person is to be indecisive. Apparently, it is more difficult to narrow down multiple choices of what is right or wrong and easier to make the choice when only a couple of alternatives are presented.

From a common sense approach, it seems logical that a child who has been taught right from wrong will have less ambiguity as an adult since he or she has a background in moral issues. It is those who have never considered the right path that will have the most difficulty making such decisions. When moral education has been provided (and accepted as truth) decisions are simply easier to make.

We could continue to study the issues of morality, which is simply acting ethically, indefinitely. We could cloud issues with multiple views and supporting facts. The topic of ethics is a complicated and complex issue. Basically, however, ethics is simply a matter of doing what we perceive to be right. Acting ethically is not a difficult thing, but it can be a struggle. People and businesses do not act ethically for multiple reasons ranging from simple laziness to indifference to ignorance. All too often greed is also an element.

Certainly, ethical behavior is practical from the legal standpoint. To behave unethically means that you may find yourself in a legal dilemma. Unethical behavior may also mean legal action against an insurance producer, the agency, and the insurance company.

A twelve year old from Ohio wrote: "If everyone did their share, no one would have to save the entire world." Although simplistic, this statement makes an amazing amount of sense. If each of us acts responsibly, everyone benefits. This is especially true in the insurance world.

There are no clear or easy answers to many of the moral dilemmas in our lives. Most of the ethical choices we have are not complicated, however. We, as insurance agents, know what is legal and what is not. We, as insurance agents, know if we have concealed necessary information from the consumers (our clients). We, as insurance agents, know if we have lied or been truthful. Each of us has personal shortcomings of some type, but ethical behavior is something that we clearly have control over. With free choice comes responsibility. No ethics course will change the reader. As in all things, each individual must make personal choices regarding their own integrity and accountability.

Being ethical simply means doing what the individual perceives to be right even when it means forgoing a commission. Each day brings multiple opportunities for going either way, but we know what we should do. Temptations will always exist; the moral person handles them without giving up their morality. This means overcoming greed, laziness, indifference, temptation and perhaps even fear. The truly committed ethical or moral person will have personal convictions by which they live. These convictions didn't happen by accident. They were convictions that were fully adopted and continually followed.
It is easy to be moral and ethical when it makes us look good or noble. It is easy to behave ethically when others will be observing us. The difficult part comes when there will be no recognition for our convictions, when we may even be unpopular or have to face another who is acting illegally or unethically. Doctor Martin Luther King, Jr. said a person's worth is "not where he stands in moments of comfort and convenience, but where he stands at times of challenge and controversy."

Maya Angelou said: “My mother said that I must always be tolerant of ignorance but understanding of illiteracy. That some people, unable to go to school, were more educated and more intelligent than college professors.” Moral convictions seldom rely solely on education. While education is likely to bring about thought, convictions are something the individual personally adopts, regardless of their educational status.

In the end, what you and your business represent will be established by your convictions, your principles, your actions and your words. It will not matter how many material things you have, what you look like or who you know. You will be defined by what you do and what you say. Who you are is the only thing that no one can take away from you. It is your final statement about yourself, your business and your life.

Irene Peter said: “Ignorance is no excuse – it’s the real thing.” There is no excuse for ignorance when it comes to ethical conduct. Insurance producers are exposed to ethical education (in most states) each license renewal period. Increasingly more states are now mandating training in insurance ethics.

We had hoped to end this course on some grand statement that insurance producers could carry with them throughout their lifetime. In the process of researching this material, however, it became evident that each person must arrive at their own grand conclusion. For in the end, we each make our own choices and choose our own life paths. We choose our own mishaps, our own miseries, our own troubles. We also choose our own principles, our own victories, our own happiness, and our own ending statement about ourselves.

Perhaps the greatest challenge is not philosophical knowledge, but rather moral understanding. The challenge is not your financial goal, but rather your moral living. The financial goal will come on its own.