

Considerations on the Purchase of Life Insurance Policies

EXECUTIVE BENEFIT SECURITY DEVICES

A life insurance contract is a complex financial instrument, and the life insurance industry offers a number of different products, each described by its own nomenclature. Trying to determine which particular product and what insurance company is appropriate for a particular situation can be very challenging for the layman. A disciplined approach to this subject is necessary in order to lessen apprehension about the various products being marketed today, about the carriers who underwrite those products, and to provide the background to ask the right questions to analyze products. *NYLEX* Benefits has the expertise to assist you in this process.

PURPOSE OF LIFE INSURANCE

The purpose of life insurance is to help create certainty out of one of the greatest financial uncertainties and risks - the realization of the economic value of a specific human life. The death of an individual inevitably creates an economic loss to other individuals or entities. Life insurance is specifically designed to underwrite this economic loss no matter when it occurs.

Life insurance is a long-term financial commitment. With life insurance, an important question is whether the carrier, over an extended period, will be able to pay the values projected in the policy illustrations.

TYPES OF LIFE INSURANCE POLICIES

The following is a brief description of the key types of policies available today.

Term Life Insurance

Term life insurance often is the most economical form of coverage for limited periods. It provides pure death insurance coverage without any associated cash value accumulation. The premium is based on the insured's age, and since the risk of dying increases each year, the premium increases. Term life insurance can be structured to have level premiums for a specific number of years, following which the annual premiums will increase. Other types of policies might be more

appropriate for needs extending ten years or longer, or if you must accumulate cash values as an underlying objective of the policy.

Whole Life Insurance

Traditional whole life insurance is designed to have level premiums and to maintain permanent coverage over the entire lifetime of the insured, provided premiums are paid when due. Cash values accumulate to cover the increasing mortality risk charges that must be assessed as the insured ages. Under a whole life policy structure, each of its elements (net premiums, investment earnings, risk charges and withdrawals) is combined to produce a net result.

UNDERSTANDING LIFE INSURANCE PREMIUMS AND DIVIDENDS

Premiums on permanent ("level premium whole life") life insurance policies are guaranteed never to increase beyond the rates outlined in the policy, even though the cost to the insurance company for providing the coverage will not be known for many years. Due to this uncertainty, premiums must be set at a conservative level, which ensures the company's ability to pay the benefits, regardless of future conditions.

The cost to the insurance company for providing the coverage is determined based on three primary factors:

- 1. Mortality.** The insurance company initially assumes a certain projected rate of mortality for the lives of those insured. This rate varies by age, product, sex, health and number of years from issue;
- 2. Expenses.** The insurance company projects future operating expenses, such as policy acquisition costs, company operating expenses, and other costs of doing business;
- 3. Investment Returns.** The insurance company initially projects a rate of return on its investments, usually based on current economic conditions.

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LIFE INSURANCE DIVIDENDS ON PARTICIPATING POLICIES

All policies issued by mutual life insurance companies, and some policies issued by stock life insurance companies, are "participating policies." Under participating policies, the insurance company's actual experience with respect to mortality, expenses and investment return is compared each year against the initial pricing assumptions. Based on the results, the insurance company declares a dividend scale for the policy year, which is applied to the credit of the policyholders.

THE DIVIDEND STRUCTURE

As noted above, the dividend is derived from the actual experience of all three factors: mortality, expenses and investment returns. The insurance company enjoys surplus earnings when actual mortality experience is better than originally assumed, and/or actual expenses turn out to be less than the original projection of expenses, and/or earnings on investments are greater than originally projected. The dividend declared by the insurance company is a distribution of some or all of these surplus earnings.

Unlike the basic premium rate, dividends on participating whole life policies are not paid at a predetermined rate nor are they guaranteed. When the insurance company's surplus increases due to improvements over the original pricing assumptions, dividends may increase as well. Even then, the insurance company reserves the right to increase or decrease its current dividend scale after taking into consideration current economic conditions and other relevant circumstances. However, because of the strong competition among life insurance companies, dividend scales historically have tended to be as liberal as a company had considered reasonable.

DIVIDEND TRENDS

During the 1980's, actual dividends consistently exceeded projections year after year, as insurance companies rode the wave of high interest rates and experienced substantial returns on investments. When interest rates began to decline in the early 1990's, most companies responded by reducing dividend scales. As a result, many policies purchased based on illustrations projecting higher dividend scales than actually experienced did not

perform according to those original illustrations. Based on current dividend scales, which are not guaranteed, a policy may be eligible to premium offset in the future. Premium Offset (POP) is an alternate method for paying premiums due. Rather than a policyholder paying premiums out-of-pocket, dividends and accumulated policy values are used to pay premiums due. A policy's ability to "POP" depends on dividend scales which are not guaranteed as well as whether loans or cash dividend withdrawals have been taken. If the dividend scale decreases, a policy may not POP as scheduled or may come off POP at a later time and additional out-of-pocket payments may be required.

It is important to recognize that the basic guarantees have not been violated. When shopping for life insurance, in addition to examining the current financial strength of the insurance company, a purchaser should look at the historic trend of the company's dividend rates over a period of time, not only at the current rates. The key is to look for a company whose rates of return do not fluctuate widely over time.

Another issue to determine is whether a company, which declares its dividend crediting rate, is stating it on a "gross" or "net" basis. A gross rate is the company's actual rate of return on its assets and the net rate is the gross rate minus investment expenses, taxes on investment yield, and any contribution to surplus. Declared rates may seem to vary widely among different companies. In all cases, the policyholder receives the "net" rate, whether or not a company chooses to declare its dividend scale on a gross rate or net rate basis.

CASH VALUE POLICIES

A cash value life insurance policy is a very long-term financial vehicle. It is important that a policyholder monitor the performance of each policy on a periodic basis, requesting revised "in-force" illustrations of the specific policy from the insurance company at least every few years.

Universal Life Insurance (U/L)

Universal life ("U/L") is an insurance contract that has elements (net premiums, investment earnings, risk charges, and withdrawals) that can be separated and measured separately. This type of policy allows the insured to vary the level of death benefit or premiums according to changing needs.

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U/L products have two basic death benefit alternatives. The first keeps the total death benefit level (Option A). The second provides that the accumulation value will be paid in addition to the specified initial face amount, providing an increasing death benefit (Option B).

The interest crediting rate, mortality charges, and expense charges are critical in determining the actual performance of the policy. Care must be taken when comparing different product illustrations. In addition, it is important to compare a carrier's past performance with the carrier's policy illustrations.

Furthermore, U/L policies are often sold based on the flexibility of being able to "skip" premium payments. However, if the initial illustration was based on annual premiums, any variation in the actual premium flow can have a significant impact on the actual policy performance. U/L policies will terminate if at any time the cash surrender value is insufficient to pay the monthly deductions. This can happen due to insufficient premium payments, if loans or withdrawals are made, or if current interest rates or charges fluctuate.

Variable Life Insurance (V/L)

A variable life insurance ("V/L") policy ties cash values and possibly death benefits to actual performance of a particular investment fund or a combination of funds, and not necessarily to the insurance company's general investment account. V/L allows the policyholder to invest the premiums among the various investment options available within the policy structure. Changes in policy values are directly linked to the performance of the funds; the policyholder assumes the risk of market value losses, and receives the full benefit of any investment gains after policy charges are deducted.

Some V/L policies guarantee that the death benefit will remain in force as long as stated premiums are paid and left in the policy, regardless of fund performance. Other policies will lapse entirely if fund performance is not adequate to cover the mortality risk charges and other policy charges as they accrue.

Because of the securities element of V/L, such policies are regulated by the SEC and NASD in addition to traditional state regulation, which

applies to all insurance policies. Variable life products may only be offered by properly licensed representatives of a broker/dealer. *Investors are asked to consider the investment objectives, risks and charges and expenses of the investment carefully before investing. The prospectus contains this and other information about the investment company. Please read the prospectus carefully before investing.*

The same precautions with regard to relying on sales illustrations apply to V/L policies as apply to U/L policies.

Joint/Survivorship/Second (or Last) -to-die /First-to-die Life Insurance

One product matures as a death claim upon the first death, the other on the death of the survivor of two or more insureds. Second-to-die is often used in husband/wife estate planning situations, where the insurance proceeds are not needed to cover estate taxes until the later of the two deaths. Mortality charges are significantly lower with second-to-die coverage than with two individual policies, since the carrier on average does not have to pay a death claim as soon.

These policies can be offered in the form of whole life (both participating and non-participating), universal life, and variable life.

Second-to-die policy features can include the ability to increase cash values and reduce or eliminate future premiums after the first death.

First-to-die policies are useful in business situations for funding stock buy-outs upon the death of the first of two or more business owners. The total premiums often are lower than if each of the individuals were insured individually.

ILLUSTRATING LIFE INSURANCE PERFORMANCE

The key in purchasing a life insurance policy is to recognize that the performance of the insurance company issuing the contract must be adequate for it to meet the eventual obligations of the contract. The ability of the carrier to live up to its illustrations is paramount. The contractual guarantees are the promises a life insurance company makes when it sells a product.

Illustrations projecting long-term results are helpful to demonstrate the mechanics behind the operation of a financial product or policy, but illustrations are rarely a good indication of long-

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term financial expectations, which are purely dependent upon the reasonableness of the underlying assumptions used to generate the illustration. Illustrations are not predictions of future long-term performance but they are useful in that they demonstrate cash flow and cost patterns based on the underlying assumptions, and can identify the potential financial consequences of the underlying assumptions used.

The number of subtle ways in which insurance illustrations can differ makes policy comparisons difficult. Independent analysis of the reasonableness of the underlying assumptions is essential. The most important rule in making comparisons is to use consistent measures for all illustrations. *NYLEX* Benefits can accomplish this by running various different products through its unique and proprietary integrated actuarial/financial modeling (“IAFM”) system.

IMPORTANCE OF CASH VALUE LIFE INSURANCE VS. “BUY TERM AND INVEST THE DIFFERENCE”

If life insurance is needed on a long term basis, cash value life insurance may be more economical. Cash value life insurance often creates a long term economic advantage over the purchase of term insurance plus using the excess funds for other investment purposes.

The consumer may be better off long term if cash value life insurance is purchased, because the pre-tax excess earnings are used to pay for the mortality cost of the policy. If the policy with a whole life type premium is kept in force for 10 to 15 years, this advantage may make cash value life insurance a more economical purchase than “buy term and invest the difference,” where the term costs are paid with after-tax dollars.

The tax effect of this economic advantage is measured by a taxpayer’s “marginal” rate, the highest tax rate that applies to the last dollar earned by the taxpayer. Furthermore, few consumers can afford the risk of trying to invest as effectively as an insurance company. With traditional insurance, the consumer has the advantage of a long term bond portfolio type return, without the market value fluctuations. This is a very valuable feature that is difficult to quantify.

IMPACT OF POTENTIAL TAX LAW CHANGES ON CASH VALUE LIFE INSURANCE

The tax advantages of cash value life insurance apply to any type of cash value product that passes through a fair share of excess earnings to the policyholder, either as dividends or other non-guaranteed elements, such as excess interest, investment results from variable unit shares, or mortality and expense (loading) gains.

The basic tax advantages are twofold:

1. Cash value accumulation (the excess of cash values over premiums paid for the policy) is not taxed until distribution and tax may be avoided completely, and
2. Death proceeds are generally free of income tax, and, can be structured to be free of estate tax.

Subject to Alternative Minimum Tax (“AMT”) rules, if the tax deferral on the cash value accumulation is eliminated, the economic advantages of life insurance will be reduced, but will still exist. Compared to the investment return on, for example, a CD, over time the cash value life insurance policy will still make economic sense. Furthermore, assuming death proceeds are received tax free, the life insurance economic advantage will continue.

If a flat tax replaces the current progressive tax system, and the tax deferred cash value accumulation continues, to the extent the marginal tax rate declines, the economic advantage of cash value life insurance would be reduced, but not eliminated. Furthermore, if tax is avoided at death, the life insurance economic advantages will continue.

USE OF VARIOUS POLICY TYPES IN COMPANY-OWNED LIFE INSURANCE (“COLI”) PLANS

COLI is commonly used by business entities to provide key-person protection and as a financing vehicle to provide informal funding for various compensation related deferred obligations, such as benefits covered under a “nonqualified,” “unfunded,” supplemental executive retirement plan (“SERP”). Various types of policies are used, as follows:

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Whole Life Insurance

Whole Life is an appropriate COLI vehicle. The premiums are level; assets are likely to grow significantly in time, mitigating accounting charges and providing the financial wherewithal (ability) for benefit funding. The policies provide a level funding, systematic, tax-favored vehicle that can be constructed to offset SERP liabilities as they are accrued.

Universal Life Insurance (“U/L”)

U/L, similar to Whole Life, is well suited for COLI.

Variable Life Insurance (“V/L”)

V/L, similar to Whole Life, is well suited for COLI

Term Life Insurance

Term Life usually is not appropriate for SERP funding, as no assets are accumulated to provide the wherewithal for benefit funding (no cash values). Accounting charges are never offset by asset values, resulting in increasing negative charges to earnings each year. Also, the cost of maintaining coverage for an individual who lives well beyond retirement age becomes prohibitive, destroying the concept of “cost-recovery”.

Joint/Survivorship/Second (or Last) -to-die /First-to-die Life Insurance

These policies are rarely suitable for COLI situations.

THE CONCEPT OF LIMITED PAY PLANS

Premiums are due periodically in most life insurance policies. Over time, cash value life insurance policies generally develop a reserve of cash inside the policy. Typically, these cash values may be borrowed via policy loans (which accrue interest charges and reduce the available death benefit) or withdrawn by the policy owner. The policy owner may elect to use this cash inside the policy to pay the periodic premiums when due.

If the policy has sufficient cash value, it becomes possible to discontinue all future out-of-pocket premium payments by using the cash value inside the policy. The use of internal cash values to pay all future premiums is known as “limited pay plans” in the insurance industry. The limited pay

concept is often confused with “paid-up” insurance, but there are significant differences.

A paid-up policy guarantees the continuation of coverage regardless of future dividend or interest crediting rates, mortality or expense charges. A limited pay product does not guarantee this continuation in coverage. The limited pay illustration depends on assumptions about future dividend or crediting interest rates, as well as mortality and expense charges, assumptions that may not be realized. If actual dividends or crediting interest rates are lower than projected, or if actual mortality or expense charges are higher, the limited pay scenario may not hold and additional premium payments may be required or coverage may decrease or lapse.

There are several key points which must be understood about limited pay plans:

1. The actual premium payment period continues throughout the insured’s life, even though future premium payments (after retirement) are anticipated to be paid from cash values and non-guaranteed credits to the policy;
2. When premiums stop being paid, the policy is not contractually paid-up on a guaranteed basis. Pre-retirement funding is usually based on what are believed to be reasonable assumptions whereby the policy premium is anticipated to be able to be maintained without additional premium payments; and
3. If non-guaranteed pricing elements (interest rates, mortality costs, marginal expenses) are less favorable than those illustrated, premium payments out-of-pocket may have to be resumed at some point in order to maintain the policy coverage.

MODIFIED ENDOWMENT CONTRACTS (MECS)

Care should be taken to avoid a life insurance policy from being classified for tax purposes as a Modified Endowment Contract (“MEC”). MEC, whose definition was added to the Internal Revenue Code (“IRC”) in the 1988 federal tax act, is a life insurance contract under which the premiums paid exceed the cumulative premiums of a seven-pay life insurance policy.

Even if a policy does become a MEC, most of the advantages of a life insurance policy still exist. However, if the insured chooses to withdraw

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money or borrow from the policy while he or she is alive, the gain on the inside build up is taxed on a LIFO (last in, first out) basis. Also, there generally is a 10% penalty tax applied to gains withdrawn before age 59-1/2.

A non-MEC policy generally will be taxed on withdrawals on a FIFO (first in, first out) basis. Loans are not taxed until the policy is surrendered, lapses or matures, but loans are not taxed at all if the policy is held to death. A MEC, such as a single premium life policy, is still usually more tax favorable than a tax deferred annuity since death proceeds for a MEC are usually still received income tax free, while an annuity will always result in a tax being paid.

NYLEX Benefits offers its clients a service that monitors each participant's policy(ies) throughout his or her lifetime to determine whether or not the policy is in danger of becoming a MEC.

About NYLEX Benefits

NYL Executive Benefits LLC (“NYLEX Benefits”) provides supplemental executive benefit programs to a wide range of commercial clients. We focus on developing cost effective executive benefit solutions that are designed to attract, reward and retain key employees.

Our services are designed to assist clients at all stages in the adoption and operation of executive benefit programs and include:

- Initial assessment
- Plan design
- Funding
- Plan implementation
- Ongoing administration

NYLEX Benefits' professional staff includes the following professional disciplines, all dedicated to supporting our client's programs, processes, systems and services:

- Accountants
- Actuaries
- Attorneys
- Benefit specialists
- Insurance specialists

We take great care to assure that client programs are practical and cost effective and that they are designed to achieve our clients' strategic and operational goals.

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