Individual Life Insurance Contract - Provisions And Options

By this point, you should have a solid working knowledge of the different types of life insurance policies and their suitability for different types of insured individuals. Now you will learn about provisions and options that operate within life insurance policies.

Provisions stipulate the rights and obligations of an insurance contract and are fairly universal from one policy to the next. **Options** offer insurers and insureds ways to invest or distribute a sum of money available in a life policy. It is essential for you to have a good understanding of the different provisions and options, and how they apply to life insurance transactions.

TERMS TO KNOW

Assignment — transfer of rights of policy ownership
Contingent beneficiary — a beneficiary who has second claim to the policy proceeds after the death of the insured (usually after the death of the primary beneficiary)
NAIC — National Association of Insurance Commissioners, an organization composed of insurance commissioners from all 50 states, the District of Columbia and the 4 U.S. territories, formed to resolve insurance regulatory issues
Primary beneficiary — a beneficiary who has the first claim to the policy proceeds after the death of the insured
Principal — the face value of the policy; the original amount invested before the earnings
Trust — an arrangement in which funds or property are held by a person or corporation for the benefits of another person (trust beneficiary)

A. Common Life Policy Provisions

Educational Objective:

II.E.7. Be able to identify the following common provisions of life policies:
insuring clause, free look, consideration clause, owner's rights, beneficiary designations, grace period, automatic premium loan, reinstatement, policy loan, incontestability, suicide, misstatement of age or sex.

While there is no "standard" policy form in life insurance, the standard policy provisions adopted by the National Association of Insurance Commissioners (NAIC) create uniformity among life insurance policies.

1. Entire Contract

The *entire contract* provision stipulates that the **policy and a copy of the application**, **along with any riders or amendments**, constitute the entire contract. No statements made before the contract was written can be used to alter the contract. Neither the insurer nor the insured may change policy provisions once the policy is in effect without both parties agreeing to it and the change being affixed to the contract.

Know This! Entire contract = policy + copy of application + any riders or amendments

2. Insuring Clause

The insuring clause (or insuring agreement) sets forth the basic agreement between the insurer and the insured. It states the insurer's promise to pay the death benefit upon the insured's death. The insuring clause usually is located on the policy face page, and also defines who the parties to the contract are, how long coverage is in force, and the type of loss insured against.

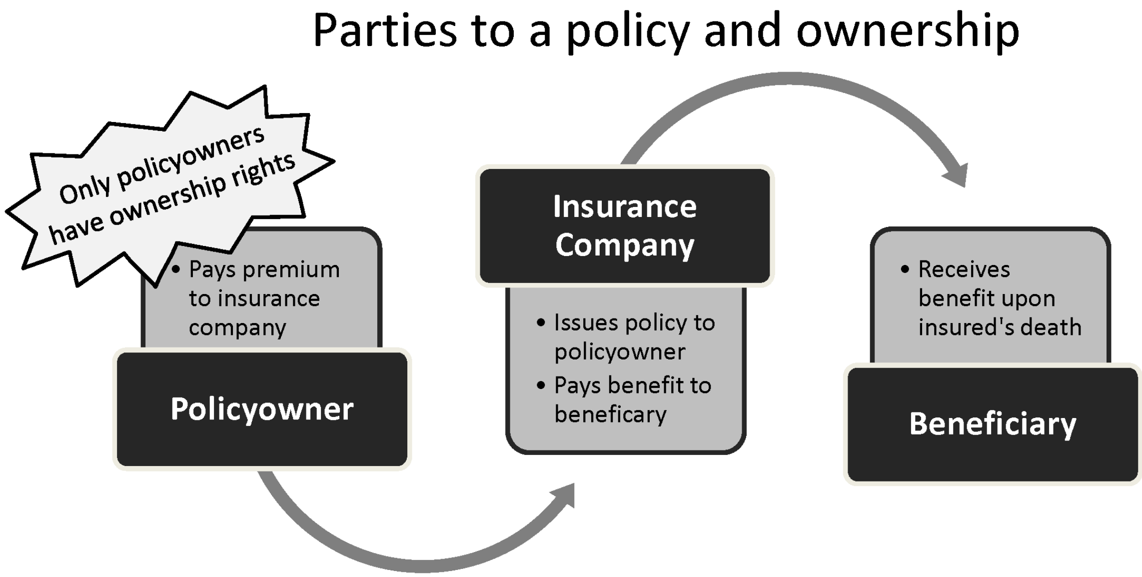
3. Consideration

Both parties to a contract must provide some value, or **consideration**, in order for the contract to be valid. The consideration provision states that the consideration (value) offered by the insured is the premium and statements made in the application. The consideration given by the insurer is the promise to pay in accordance with the terms of the contract. The consideration clause is not always a separate provision, but is often included in the entire contract provision. A separate provision concerning the payment of policy premiums is usually also found in the policy.

4. Ownership

The parties to the insurance contract are the insurer, the policyowner, the insured, and the beneficiary. The policyowner and the insured may be the same person or different persons. Regardless, only the policyowner has the ownership rights under the policy, and not the insured or the beneficiary. Among the ownership rights are naming and changing the beneficiary, receiving the policy's living benefits, selecting a benefit payment options, and assigning the policy.

The *policyowner* has the responsibility of paying the policy premiums, and is also the person who must have an insurable interest in the insured at the time of application for the insurance. When the owner and the insured are not the same person, the insurance arrangement is referred to as the third-party ownership.



Policyowner's Rights

Educational Objective:

II.E.7.d. Be able to identify owner's rights, including:

i. Assignment or transfer of policy
ii. Selecting or changing payment mode
iii. Selecting or changing beneficiaries
iv. Conversion privilege (when applicable)
v. Cash values
vi. Dividends
vii. Surrender charges and periods

Assignment or Transfer of Policy

The policyowner of a life insurance policy has the right to transfer partial or complete ownership of the policy to another person without the consent of the insurer. However, the owner must notify the insurer in writing of the assignment. Without a written notice, the insurer may not recognize the assignment and would not assume responsibility for its validity. The company's major concern is paying the claim twice. Transfer of the life insurance policy **does not change the insured or amount of coverage**; it only changes who has the policy ownership rights.

The assignment provision specifies the policyowner's right to assign (transfer rights of ownership) the policy. The policyowner must advise the insurer in writing of the assignment. There are 2 types of policy assignment:

- **Absolute Assignment** – involves transferring **all rights** of ownership to another person or entity. This is a permanent and total transfer of all the policy rights. The new policyowner does not need to have an insurable interest in the insured.
- **Collateral Assignment** – involves a transfer of **partial rights** to another person. It is usually done in order to secure a loan or some other transaction. A collateral assignment is a partial and temporary assignment of some of the policy rights. Once the debt or loan is repaid, the assigned rights are returned to the policyowner.

Know This! Absolute assignment is the complete and permanent transfer of ownership rights; collateral assignment is the partial and temporary transfer of rights.

Selecting or Changing Premium Modes

The policyowner has a right to change the frequency of premium payment on any policy anniversary as long as payment is not less than a minimum amount specified by the insurance company.

Most insurers offer several ways in which the premium may be paid, such as the following:

- Annually;
- Semiannually;
- Quarterly; or
- Monthly.

For premium modes other than annual, the insurer may include a surcharge to cover the cost of the additional billings and the loss of income from not having the full annual premium to invest for the entire policy year.

If, after a policy has been issued on an annual premium mode basis, the policyowner requests to change the premium mode to a more frequent one (e.g., monthly or quarterly), the insurer can require that the insured prove continued insurability.

Selecting or Changing Beneficiaries

The policyowner typically has the right to change beneficiaries at will (by designating a revocable beneficiary); however, if a policyowner names an *irrevocable* beneficiary, the *consent of the beneficiary is required to change beneficiaries*. Also, if an irrevocable beneficiary is named, the policyowner would not be able to take out a policy loan without the consent of the irrevocable beneficiary.

Selecting or Changing Settlement Options

Insureds and beneficiaries have choices as to how they may receive proceeds from life insurance policies. These choices are called **settlement options.** The type of settlement option chosen typically depends upon whether the beneficiary prefers a single, lump sum payment or payments over a period of time. Insureds and beneficiaries have the right to select and change their settlement options. Insurers must pay benefits according to the option chosen within 30 days of the death of the insured. If insurers do not pay within 30 days, beneficiaries have the right to have interest on the benefit amount paid to them.

Conversion Privilege

Conversion privilege in individual life insurance policies allows the policyowner to elect to have a new policy issued prior to the expiration of an existing policy. Most commonly, a conversion right is exercised when the policyowner converts the term policy to a cash-value permanent policy.

Conversion privilege may be exercised for dependents' coverage. When a dependent covered under an individual life insurance policy reaches the limiting age for coverage, the insurer must provide the dependent the privilege to convert coverage to an individual policy of their own without evidence of insurability. Most states require that the insurer give a written explanation of the rights of the dependent prior reaching such age.

Cash Values and Dividends

The policyowner has the right to surrender the policy for its current cash value at a time when coverage is no longer needed or affordable. Once this option is selected, the insured is no longer covered.

An insurance company's surplus is called **dividends.** Most participating policies are issued by mutual companies. The owners of mutual companies are their insureds. As owners, the insureds have the right to share in any surplus the company earns each year. California law requires the dividends of an insurance company be credited to participating policies on the anniversary date of the policies if all premiums are current. Extended term or reduced paid-up policies are not included. Typically, insureds will not receive dividends on policies that have been in effect for less than 5 years because the early costs of the policy are being paid at this time.

Surrender Charges

A **surrender charge** is a fee charged to the insured when a policy or annuity is surrendered for its cash value.

5. Free Look (Right to Return and Right to Examine)

This provision allows the policyowner **10 days** from receipt to look over the policy and if dissatisfied for any reason, return it for a full refund of premium. **The free-look period starts when the policyowner receives the policy (policy delivery)**, not when the insurer issues the policy. Certain life insurance transactions, such as replacement, may require a longer free-look period.

6. Payment of Premium

The policy stipulates when the premiums are due, how often they are to be paid (monthly, quarterly, semiannually, or annually) and to whom. If the insured dies during a period of time for which the premium has been paid, the insurer must refund any unearned premium along with the policy proceeds. The payment of premium provision also stipulates that premiums must be paid in advance.

Most life insurance policies have a **level premium**, which means that the premium remains the same throughout the duration of the contract. **Flexible premium** policies allow the policyowner to increase or decrease the premium during the policy period.

7. Grace Period

The grace period is the period of time after the premium due date that the policyowner has to pay the premium before the policy lapses. The purpose of the grace period is to protect the policyholder against an unintentional lapse of the policy. If the insured dies during this period, the death benefit is payable; however, any unpaid premium will be deducted from the death benefit.

In California, each individual and group life insurance policy must contain a provision for a **grace period** of at least **60 days** from the premium due date. The 60-day grace period may not run concurrently with the period of paid coverage.

8. Reinstatement

The reinstatement provision allows a lapsed policy to be put back in force. The maximum time limit for reinstatement is usually **3 years** after the policy has lapsed. If the policyowner elects to reinstate the policy, he/she will have to provide evidence of insurability. The policyowner is required to pay all back premiums plus interest, and may be required to repay any outstanding loans and interest. The advantage to reinstating a lapsed policy as opposed to purchasing a new one is that the policy will be restored to its original status, and retain all the values that were established at the insured's issue age.

Note that a policy that has been surrendered cannot be reinstated.

9. Incontestability

The **incontestability** clause prevents an insurer from denying a claim due to statements in the application after the policy has been in force for **2 years**, even if there has been a material misstatement of facts or concealment of a material fact. During the first 2 years of the policy, an insurer may contest a claim if the insurer feels that inaccurate or misleading information was provided in the application. The incontestability period does not apply in the event of nonpayment of premiums; it also does not usually apply to statements relating to age, sex or identity.

10. Misstatement of Age and Sex

Because the age and gender of an insured are important to the premium that will be charged for a life insurance policy, a provision which allows the insurer to adjust the policy at any time due to a misstatement of age or gender is included in the policy. If the applicant has misstated his or her age or gender on the application, in the event of a claim, the insurer is allowed to adjust the benefits to an amount that the premium at the correct age or gender would have purchased. The proceeds calculations should be based on the insurer's rate at the date of policy issue.

Know This! Misstatement of age on the application will result in adjustment of premiums or benefits.

11. Exclusions

<u>Educational Objective:</u>

II.E.11. Be able to identify common policy exclusions:

a. War or military service
b. Aviation
c. Illegal activity
d. Know that suicide during the contestability period usually results in a refund of premiums paid, not payment of the death benefit
e. Know that hazardous hobbies or occupations may result in the exclusion of certain causes of death by endorsement, resulting in a refund of premiums paid

Exclusions are the types of risks the policy will not cover. Certain exclusions are standard for all policies, while others are attached to the policy as an exclusion rider. The most common exclusions found in life insurance policies are aviation, hazardous occupation, and war and military service.

Aviation — Most life insurance will cover an insured as a fare-paying passenger or a pilot on a regularly scheduled airline, but will exclude coverage for noncommercial pilots, or require an additional premium for the coverage.

Hazardous Occupations or Hobbies — If the insured is engaged in a hazardous occupation or participates in hazardous hobbies (such as skydiving or auto racing), death that results from the hazardous occupation or hobby may be excluded from coverage. If excluded, premiums paid will be refunded. The underwriter also has the option of charging a higher premium for insuring these risks.

War or Military Service — Most life insurance policies issued today do not exclude military service. However, there are actually two different types of exclusions that may be used to limit the death benefit if the insured dies as a result of war, or while serving in the military. The **status clause** excludes all causes of death while the insured is on active duty in the military. The **results clause** only excludes the death benefit if the insured is killed as a result of an act of war (declared or undeclared).

This provision states that liability will be denied if the insured is injured while committing an **illegal act** or is engaged in an **illegal occupation**.

Suicide

The **suicide** provision in life insurance policies protects the insurers from individuals who purchase life insurance with the intention of committing suicide. Insurance policies usually stipulate a period of time during which the death benefit will not be paid if the insured commits suicide. If the insured dies by suicide within **2 years** following the policy effective date (issue date), the insurer's liability is limited to a refund of premium. If the insured dies by suicide after the 2-year period, the policy will pay the death proceeds to the designated beneficiary the same as if the insured had died of natural causes.

B. Beneficiaries

1. Designation Options

The *beneficiary* is the person or interest to which the policy proceeds will be paid upon the death of the insured. The beneficiary may be a person, class of persons (sometimes used with children of the insured), the insured's estate, or an institution or other entity such as a foundation, charity, corporation or trustee of a trust. Trusts are commonly used in conjunction with beneficiary designations to manage life insurance proceeds for a minor or for estate tax purposes (although naming a trust as beneficiary does not avoid estate taxes).

The beneficiary does not have to have an insurable interest in the insured. In addition, the policyowner does not have to name a beneficiary in order for the policy to be valid.

Individuals

The owner of a life insurance policy may name any individual as a beneficiary for the policy proceeds. The owner may name more than one individual, in which case the individual beneficiaries will split the benefit by the percentage specified in the policy.

Benefits designated to a **minor** will either be paid to the minor's guardian, or paid to the trustee of the minor if the trust is the named beneficiary, or paid as directed by a court. The guardian and trustee can be the same person. It is generally accepted not to be a good practice to have life insurance benefits payable to a minor.

Classes

A class of beneficiary is using a designation such as "my children." This term can be vague if the insured has been married more than once, has adopted children, or has children out of wedlock. An example of a class that is less vague is "children of the union of Jane Smith and James Smith." Many insurers encourage the insured to name each child specifically and to state the percentage of benefit they are to receive.

When naming beneficiaries, it is most prudent to be specific by naming each individual and by designating the exact amount to be given for that individual. Two class designations are available for use when an insured chooses to "group" the beneficiaries: **per capita** and **per stirpes**. Per capita, meaning *by the head*, evenly distributes benefits among the living named beneficiaries. Per stirpes, meaning *by the bloodline*, distributes the benefits of a beneficiary who died before the insured to that beneficiary's heirs.

For example, Bryan purchased a $90,000 life insurance policy. He named his three sons, Quentin, Steve, and Patrick, as beneficiaries for equal shares. Quentin has two children of his own, Bob and Lou. Steve and Patrick are both married but have no children. Unfortunately, Quentin predeceases Bryan.

If Bryan selected the **per capita** designation, which means "by the head," with Quentin gone, only 2 named beneficiaries remain. Steve & Patrick each will receive $45,000 ($90,000 divided by 2). Quentin's children would not receive any benefits, since they were not named as beneficiaries.

If Bryan selected the **per stirpes** designation, which means "by the bloodline," Steve and Patrick would receive $30,000 each and Quentin's sons would share his allotment equally at $15,000 each.

Estates

If none of the beneficiaries is alive at the time of the insured's death, or if no beneficiary has been named, the insured's **estate** will automatically receive the proceeds of a life insurance policy. The death benefit of the policy may be included in the insured's taxable estate if this occurs.

Know This! If NO beneficiary is named, policy proceeds go to the insured's estate.

Trusts

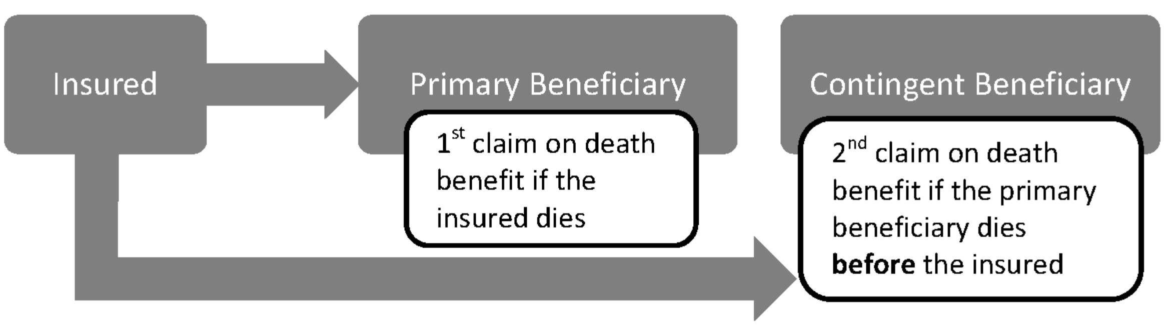
Trusts are commonly established for minors, or to create a scholarship fund. Trusts can be used for estate planning purposes, and when used properly, can keep life insurance death proceeds out of the insured's taxable estate. They are, however, expensive to administer.

2. Succession

The beneficiary designation provides for levels of priority or choice. In the event that the primary beneficiary predeceases the insured, the contingent (secondary or tertiary) level in the succession of beneficiaries will be entitled to the death proceeds. Each level in the succession of beneficiaries is only eligible for the death benefit if the beneficiary(s) in the level(s) above them has died before the insured.

The **primary beneficiary** has first claim to the policy proceeds following the death of the insured. The policyowner may name more than one primary beneficiary, as well as how the proceeds are to be divided.

The **contingent beneficiary** (also referred to as *secondary* or *tertiary* beneficiary) has second claim in the event that the primary beneficiary dies before the insured. Contingent beneficiaries do not receive anything if the primary beneficiary is still living at the time of the insured's death.



3. Revocable vs. Irrevocable

Beneficiary designations may be either revocable or irrevocable. The policyowner, without the consent or knowledge of the beneficiary, may change a **revocable** designation at any time. An **irrevocable** designation may not be changed *without the written consent of the beneficiary*. Irrevocable beneficiaries have a vested interest in the policy; therefore, the policyowner may not exercise certain rights *without the consent of the beneficiary*. In addition to being unable to change the beneficiary designation, the policyowner cannot borrow against the policy's cash value (as this would decrease the policy face value until repaid) or assign the policy to another person *without the beneficiary's agreement*.

4. Common Disaster Clause

If the insured and the primary beneficiary die at approximately the same time from a common accident with no clear evidence as to who died first, a problem may arise in identifying which party is eligible for the death benefit. The **Uniform Simultaneous Death Law** has been adopted by most states to address this problem, and to protect the policyowner's original intent, as well as to protect the contingent beneficiary. This law stipulates that if the insured and the primary beneficiary died in the same accident and there is no sufficient evidence to show who died first, the policy proceeds are to be distributed as if the primary beneficiary died first.

The **Common Disaster Clause**, when added to a policy, provides that if the insured and the primary beneficiary died in a common disaster (even if the beneficiary outlived the insured by a specified number of days), it is presumed that the primary beneficiary died first, so the proceeds will be paid to either the contingent beneficiary or to the insured's estate, if no contingent beneficiary is designated. Most insurers specify a certain period of time, usually 14 to 30 days, in which the primary beneficiary's death must occur in order for the Common Disaster Clause to apply. As long as the beneficiary dies within this specified period of time following the death of the insured, it will still be interpreted that the beneficiary died first. The intent is to fulfill the wishes of the policyowner in regard to payment of proceeds to beneficiaries.

Example:

James had a life insurance policy that included a Common Disaster Clause. James was the insured; his wife Maggie was named the primary beneficiary, and his son Ben was named the contingent beneficiary. James and Maggie got in a terrible car accident, and James died immediately, but Maggie died 4 days later from her injuries from the same accident. Because the policy included the Common Disaster Clause, the death benefit would be paid to Ben, the contingent beneficiary, as if Maggie, the primary beneficiary, had died *before* James, the insured.

Know This! Common disaster clause protects the contingent beneficiary.

5. Spendthrift Clause and Rights of Beneficiaries and Creditors

The **spendthrift clause**, when included in a life insurance policy, protects beneficiaries from the claims of their creditors, as well as prevents the beneficiary's reckless spending of benefits by requiring that the benefits be paid in a fixed period or fixed-amount installments. The beneficiary does not have the right to select a different settlement option and is not allowed to assign or borrow any of the proceeds. The spendthrift clause is designed to protect life insurance policy proceeds that have not yet been paid to a named beneficiary from the claims of the creditors of the beneficiary or policyowner.

C. Policy Loans

The **policy loan** option is found only in policies that contain cash value. The policyowner is entitled to borrow an amount equal to the available cash value. Any outstanding loans, and accrued interest, will be deducted from the policy proceeds upon the insured's death. The policy will not lapse with an outstanding policy loan unless the amount of the loan and accrued interest exceeds the available cash value. However, the insurer must provide **30 days' written notice** to the policyowner that the policy is going to lapse. Insurance companies may defer a policy loan request for **up to 6 months**, unless the reason for the loan is to pay the policy premium. Policy loans are not subject to income taxation.

Know This! Policy loans are ONLY available in policies that have cash value (whole life).

1. Cash Loans

Whenever a policy has cash value, it has loan value. The amount available to the policyowner for a loan equals the cash value minus any outstanding and unpaid policy loans including interest.

Loan value = Cash value – (unpaid loans + interest)

If there are outstanding loans at the time of the insured's death, the loan amount will be considered a debt to the policy and the death benefit will be reduced by the amount of indebtedness.

Example:

Vera has a whole life policy with a $150,000 face amount. Three years ago she took out a $50,000 policy loan, which has accrued $3,500 in interest. If Vera dies, the policy's death benefit will be $150,000 - $50,000 - $3,500 or $96,500.

2. Automatic Premium Loans

The automatic premium loan provision is not required, but is commonly added to contracts with a cash value at no additional charge. This is a special type of **loan that prevents the unintentional lapse of a policy** due to nonpayment of the premium. *For example*, a loan against the policy cash value for the amount of premium due is automatically generated by the insurer when the policyowner has not paid the premium by the end of the premium-paying grace period. It is a loan for which the insurer will charge interest. If the loan and interest are not repaid and the insured dies, then it will be subtracted from the death benefit. While the insurer may defer requests for other loans for a period of up to **6 months**, loan requests for payment of due premiums must be honored immediately.

Usually, the policyowner must specifically elect this provision in writing to make it effective.

D. Nonforfeiture Options

Policyowners have decisions to make about how the cash value in the policy should be protected, how the return of excess premium (dividends) should be invested, and how benefit payments will be made. The different choices available to them are categorized as Nonforfeiture Options, Dividend Options, and Settlement Options.

Educational Objective:

II.E.8. Be able to differentiate the three Nonforfeiture Options: *cash surrender, reduced paid up, and extended term.*

Because permanent life insurance policies have cash values, certain guarantees are built into the policy that **cannot be forfeited** by the policyowner. These guarantees (known as nonforfeiture values) are required by state law to be included in the policy. A table showing the nonforfeiture values for a minimum period of 20 years must be included in the policy. The policyowner chooses one of the following nonforfeiture options: cash surrender value, reduced paid-up insurance, or extended term.

Know This! Nonforfeiture options are triggered by policy surrender or lapse.

1. Reduced Paid-up Insurance

Under this option, the policy cash value is used by the insurer as a single premium to purchase a completely paid-up permanent policy that has a **reduced face amount** from that of the former policy. The new reduced policy builds its own cash value and will remain in force until death or maturity.

2. Extended Term

Under the extended-term option, the insurer uses the policy cash value to convert to term insurance for the **same face amount** as the former permanent policy. The duration of the new term coverage lasts for as long a period as the amount of cash value will purchase. If the policyowner has neglected to select one of these nonforfeiture options, the insurer will **automatically** implement the extended-term option in the event of termination of the original policy.

Know This! Extended term is the *automatic* nonforfeiture option: same face amount, shorter term of coverage.

3. Cash Surrender Value

The policyowner simply surrenders the policy for the current cash value at a time when coverage is no longer needed or affordable. Upon receipt of the cash surrender value, if the cash value exceeds premiums paid, the excess is taxable as ordinary income. Once this option is selected, the insured is no longer covered. A policy that has been surrendered for its cash value cannot be reinstated. A *surrender charge* is a fee charged to the insured when a life policy or annuity is surrendered for its cash value.

<u>Example:</u> (review a sample Table of Guaranteed Values below):

If the insured chooses to exercise the reduced paid-up option at the end of 15 years, the cash value of $8,100 can be used as a single premium to purchase paid-up insurance of the same type as the original policy. The insured doesn't have to pay any more premiums, while still retaining some amount of life insurance (in this example, $21,750).

The extended-term option indicates the option to use the policy's cash value to purchase in a single premium a term insurance policy in an amount equal to the original policy's face value (in this case, term insurance with $50,000 face amount). The insurance company determines that for this particular insured, $8,100 of cash value is worth 18 years and 8 days of $50,000 of protection.

Table of Guaranteed Values
$50,000 Whole Life Nonforfeiture Table (20 years)

End of Policy Year **Cash or Loan Value** **Reduced Paid-up** **Extended Term**

YearsDays
1$0$0060
2$50$2500122
3$400$1,6002147
4$950$3,600527
5$1,550$5,6507183
6$2,150$7,6009185
7$2,750$9,4001152
8$3,350$11,10012186
9$4,000$12,85013315
10$4,650$14,500156
11$5,300$16,05015333
12$6,000$17,60016249
13$6,700$19,1001795
14$7,400$20,45017255
15$8,100$21,750188
16$8,650$23,05018116
17$9,850$24,44018208
18$10,400$25,55018227
19$11,200$26,75018231
20$12,000$27,85018200
Provides the most
Lasts the longest

E. Dividend Options

<u>Educational Objective:</u>

II.E.10. Be able to identify the dividend options that may be available to policyowners, including *cash payments, accumulation at interest, paid-*

up additions, reduced premium payment, one-year term.

Dividends are paid only on participating policies. When the policyowner purchases a policy from a participating insurer, he or she actually pays a "grossed-up" premium. The higher premium is charged as a safety margin in the event the insurer's losses are higher than anticipated. If this extra amount is not needed by the insurer to pay death claims and expenses, or if actual mortality experience improves or interest earned by the company exceeds the assumptions, a dividend will be returned to the policyowner. In other words, dividends are a return of excess premiums, and for that reason they are **not taxable** to the policyowner. Insurance companies **cannot guarantee** dividends.

The first dividend could be paid as early as the first policy anniversary, but must occur **no later than the end of the third policy year**. From then on dividends are usually paid on an annual basis. Policyowners have the option of taking their dividends in one of several different ways.

Know This! Dividends are a return of excess premiums; therefore, not taxable when paid to the policyowner.

1. Cash Payments

The insurer simply sends the policyowner a check for the amount of the dividend as it is declared, usually annually.

2. Reduced Premium Payment

The insurer uses the dividend to reduce the next year's premium. *For example*, if the policyowner usually pays an annual premium of $1,000 and the insurer declares a $100 dividend, the policyowner would only pay a $900 premium that year.

3. Accumulation at Interest

The insurance company keeps the dividend in an account where it accumulates interest. The policyowner is allowed to withdraw the dividends at any time. The amount of interest is specified in the policy and compounds annually. Although the dividends themselves are not taxable, the **interest on the dividends is taxable** to the policyowner when credited to the policy, whether or not the policyowner receives the interest.

4. Paid-Up Additions

The dividends are used to purchase a single premium policy in addition to the face amount of the permanent policy. No new separate policies are issued; however, each of these small single premium payments will **increase the death benefit** of the original policy by whatever amount the dividend will buy. In addition, each of these paid-up policies will accumulate cash value and pay dividends. The amount of additional coverage that can be purchased with the dividend is based on the insured's attained age at the time the dividend is declared.

If the policyowner did not chose the dividend option, the insurer will **automatically** use paid-up additions to increase the death benefit of the original policy by the amount the dividend will buy.

5. One-Year Term

The insurance company uses the dividend to purchase additional insurance in the form of **one-year term insurance** that increases the overall policy death benefit. The policyowner's choice is to either use the dividend as a single premium on as much one-year term insurance as it will buy, or to purchase term insurance equal to the policy's cash value for as long as it will last. If the insured dies during the one-year term, the beneficiary receives both the death benefit of the original policy and the death benefit of the one-year term insurance.

F. Settlement Options

Educational Objective:

II.E.9. Be able to identify the common death benefit and annuity settlement options and why each might be selected: *lump sum, fixed amount, fixed period, life income, interest only.*

Settlement options are the methods used to pay the death benefits to a beneficiary upon the insured's death, or to pay the endowment benefit if the insured lives to the endowment date. The policyowner may select a settlement option at the time of policy application, and may also change that option at any time during the life of the insured. Once selected by the policyowner, the settlement option cannot be changed by the beneficiary. If the policyowner does not select a settlement option, the beneficiary will be allowed to choose one at the time of the insured's death.

Know This! Settlement options are triggered by the insured's death or age 100.

1. Cash Payment

Upon the death of the insured, or at the point of endowment, the contract is designed to pay the proceeds in cash, called a **lump sum**, unless the recipient chooses a different mode of settlement. If no selection is made, the proceeds are **automatically** paid to the beneficiary in a single cash payment. As a rule, payments of the principal face amount after the insured's death are not taxable as income.

2. Life Income

The **life-income option**, also known as **straight life**, provides the recipient with an income that he or she cannot outlive. Installment payments are guaranteed for as long as the recipient lives, irrespective of the date of death. The amount of each installment paid is based on the **recipient's** life expectancy and the amount of principal. If the beneficiary lives for a very long time, payments may exceed the total principal. However, if the beneficiary dies shortly after he or she begins receiving installments, the balance of the principal is forfeited to the insurer. Because there is a chance that the beneficiary may not live long enough to receive all the life insurance proceeds, insurers make options available which provide at least a partial guarantee that some or all of the proceeds will be paid out. With each of the guarantees, the size of the installment is decreased.

Know This! Under life-income (straight life) settlement option, the recipient cannot outlive the benefit payments.

Single Life

The **single life option** can provide a single beneficiary income for the rest of his/her life. Upon the death of the beneficiary, the payments stop.

Joint and Survivor

The **life income joint and survivor** option guarantees an income for two or more recipients for as long as they live. Most contracts provide that the surviving recipient will receive a reduced payment after the first recipient dies.

Most commonly, the reduced option is written as “joint and ½ survivor” or "joint and 2/3 survivor,” in which the surviving beneficiary receives ½ or 2/3 of what was received when both beneficiaries were alive. This option is commonly selected by the policyowner who wants to protect two beneficiaries, such as elderly parents. Unless a period certain option is also chosen, as with the life income option, there is no guarantee that all the life insurance proceeds will be paid out if all beneficiaries die shortly after the installments begin. This option guarantees, however, an income for the lives of all beneficiaries.

Life Refund

The **life refund income** option comes in either a *cash refund* form or an *installment refund* form. Both options guarantee that the total annuity fund will be paid out to the annuitant or to the beneficiary. The difference between the two options is that under the **cash refund option**, if the annuitant dies before the annuity fund is depleted, a lump-sum settlement of the remainder would be made to the beneficiary, while under the **installment refund option,** the beneficiary would receive the remaining funds in the form of continued annuity payments.

Life with Period Certain

Under **life income with period certain option**, the recipient is provided with the "best of both worlds" in terms of a lifetime income and a guaranteed installment period. Not only are the payments guaranteed for the lifetime of the recipient, but there is also a specified period that is guaranteed. *For example*, a life income with 10 years certain option would provide the recipient with an income for as long as he or she lives. If the recipient dies shortly after starting to receive the payments, the payments will be continued to a beneficiary for the remainder of the 10-year period. As already stated, the installments for the life income with period certain option will be smaller than the life income only option.

3. Interest Only

With the **interest-only option**, the insurance company retains the policy proceeds and pays interest on the proceeds to the recipient (beneficiary) at regular intervals (monthly, quarterly, semiannually, or annually). The insurer usually guarantees a certain rate of interest and will often pay interest in excess of the guaranteed rate. The interest option is considered to be a temporary option since the proceeds are retained by the insurer until some later point when the proceeds are paid out in a lump sum or paid under one of the other settlement options. When the beneficiary is allowed to select a settlement option, the interest option is sometimes used as a temporary option if the beneficiary needs some time to decide which settlement option to select. *For example,* the policyowner may specify that interest only will be paid annually to the surviving spouse, with the principal to be paid to their children when they reach a certain age or at the death of the surviving spouse.

4. Fixed-period Installments

Under the **fixed-period installments option** (also called **period certain**), a specified period of years is selected, and equal installments are paid to the recipient. The payments will continue for the specified period even if the recipient dies before the end of that period. In the event of the recipient's death, the payments would continue to a beneficiary. The size of each installment is determined by the amount of principal, guaranteed interest, and the length of period selected. The longer the period selected, the smaller each installment will be. This option does not guarantee income for the life of the beneficiary; however, it does guarantee that the entire principal will be distributed.

5. Fixed-amount Installments

The **fixed-amount installments option** pays a fixed, specified amount in installments until the proceeds (principal and interest) are exhausted. The recipient selects a specified fixed dollar amount to be paid until the proceeds are gone. If the beneficiary dies before the proceeds are exhausted, installments will continue to be paid to a contingent beneficiary until all proceeds have been paid out. With this option, the size of each installment will determine how long benefits will be received. The larger the installment, the shorter the income period will be. As with the fixed-period option, this option does not guarantee payments for the life of the beneficiary, but does guarantee that all proceeds will be paid out.

OPTION TYPE	AVAILABLE OPTIONS
Nonforfeiture Options	• Reduced Paid-up • Extended Term *(automatic)* • Cash
Dividend Options	• Cash • Reduction of Premium • Accumulation at Interest • Paid-up Additions *(automatic)* • Paid-up Insurance • One-year Term
Settlement Options	• Cash *(automatic)* • Life Income • Interest Only • Fixed Period • Fixed Amount

G. Chapter Recap

In this chapter, you learned about provisions and options in life insurance policies. Remember that provisions state the rights and obligations under the contract and options specify ways to distribute policy proceeds. Let's recap the major points of this chapter:

POLICY PROVISIONS	
Standard Provisions	• Entire contract • Payment of premiums • Grace period • Reinstatement • Incontestability • Misstatement of age • Statements of the insured • Legal action • Payment of claims
Other Provisions	• Ownership • Assignment • Modifications • Free look • Medical examination • Exclusions

Beneficiaries	• Designations: individuals, classes, estates, minors, trusts
	• *Succession* - the levels of priority. Each level in the succession is only eligible if the beneficiary in the level above has died:
	  ◦ *Primary* - first claim to the policy proceeds
	  ◦ *Contingent* (secondary, tertiary) - next claim after primary
	• Policyowner's right to change a beneficiary:
	  ◦ *Revocable* - can be changed at any time
	  ◦ *Irrevocable* - can only be change with the beneficiary's consent
	• *Common disaster clause* - protects the rights of contingent beneficiaries; if the insured and the primary beneficiary died at approximately the same time, it is assumed that the primary beneficiary died first
	• *Spendthrift clause* - protects policy proceeds from the claims of creditors

Policy Loans, Withdrawals and Partial Surrenders	• *Cash loans available* - policy's cash value minus any unpaid loans and interest • *Automatic premium loans* - prevent unintentional policy lapse due to nonpayment of premium • *Withdrawals and partial surrenders* - available in universal life; a charge may apply
OPTIONS	
Nonforfeiture	• *Cash surrender value* - after that, no more insurance • *Extended term* - automatic option; uses cash value to convert to term insurance

	• *Reduced paid-up insurance* - uses cash value as a single premium to purchase a permanent policy with a reduced face amount
Dividend	• *Cash* - insurer sends a check to the insured • *Reduction of premiu*m - dividend is applied to the next year's premium • *Accumulation at interest* - insurer keeps the dividend in an account where it accumulates interest • *Paid-up addition* - dividend is used to increase the face amount • *One-year term* - dividend is used to buy additional insurance
Settlement	• *Cash* - lump-sum payment; usually not taxable • *Life income* - provides an income the beneficiary cannot outlive; no guarantee that the principal will be paid out (if the beneficiary dies too soon); available as single life or as joint and survivor • *Interest o*nly - insurer retains the principal and only pays out interest • *Fixed period* - payments for a specified time period until all the proceeds are paid out • *Fixed amount* - payments in specified amounts until all the proceeds are paid out