HIGHLIGHTER
Financial Underwriting

What Is Financial Underwriting?	Financial Underwriting is the evaluation of a prospective insured's personal or business financial background and current economic situation. The analysis of an individual's financial situation takes place every time a case is underwritten, although the depth of this evaluation is based on the amount of insurance applied for. The purpose of this evaluation is to determine the proposed insured's need for insurance and make sure that the amount of insurance applied for is reasonable and in line with his or her needs.
Why Is Financial Underwriting Important?	Financial Underwriting is important to prevent over-insurance. Over-insurance occurs when the amount of life insurance in force on an individual exceeds his or her economic or "human life" value. The primary purpose of life insurance is to provide funds to help replace the economic loss that results from the premature death of the insured person. If the amount of insurance carried on an individual exceeds any possible loss on the part of the beneficiary, it could be considered speculative and it is not in the insured's or the company's best interest.
Insurable Interest	For a life insurance purchase to be valid, the beneficiary must have an insurable interest in the proposed insured. Insurable interest exists if the beneficiary benefits financially from the proposed insured's continued existence and would suffer a financial loss at the death of the insured.
Premium Payer	Who pays the premium is an important factor for underwriting to consider in evaluating a case. While the premium payer will most frequently be the insured, there are many acceptable reasons for someone else to pay the premiums, including certain business and estate planning situations, or when coverage is requested on a dependent child or spouse. If someone other than the insured is paying the premiums, underwriting will look at the relationship of the premium payer to the insured and the reason he or she is paying the premiums. The premium payer's income and the total amount of insurance the premium payer has on his or her own life are evaluated to determine the total amount of risk and the validity of the case.
Affordability	Affordability is an important factor that must be evaluated to determine if a product recommendation is suitable to meet a customer's needs. There are two basic relationships that underwriting looks at in evaluating whether a client will be able to sustain the premiums: **Premium to Income Relationship.** In conjunction with the Income Factor Tables (Refer to the Income Factor Tables section of this highlighter for the tables), the relationship of premium outlay to the proposed insured's gross annual income is considered. A good rule of thumb is that the total premium outlay for all life insurance policies supported by the premium payer's income should not exceed 10% of the premium payer's before-tax income. In certain situations, it may be acceptable, from a Financial Underwriting perspective, for premiums to be as high as 20%. If you feel such a case is warranted, contact Underwriting before submitting an application for insurance. **Be sure to provide Underwriting with a cover letter outlining why you believe the need and amount of coverage are warranted and why the premiums are affordable.** **Premium to Liquid Net Worth Relationship.** If the premium to before tax income relationship is greater than 10%, premiums may need to be paid from a client's liquid assets. In that case, it becomes necessary to consider whether the premium payer's liquid net worth is sufficient to sustain the premiums and whether this is an appropriate use of these assets. The answers to these questions will be dependent on the proposed insured's overall financial situation. A good rule of thumb is that the premium should not exceed 25% of the premium payer's liquid net worth.

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Amount of Insurance	Underwriting will also evaluate how the amount of insurance being requested was determined. Results from a comprehensive needs analysis, or recommendations from an accountant, attorney, or other advisor, can make a difference when evaluating the case. If the proposed insured simply told you how much insurance he or she wanted to purchase, you should determine if that amount of insurance is reasonable and convey that information to Underwriting. When determining the overall amount of insurance that will generally be granted to an individual, the underwriters take into account any existing insurance coverage he or she already has in force and any insurance being applied for with other companies. A complete needs analysis takes these factors into account and is an important and useful tool in helping the producer, the client, and the underwriter understand how much insurance is required and why. (**Note**: A Financial Supplement form is required for all applications with face amounts of $5,000,000 or more if the case was submitted with a new application.) In most situations, the amount of insurance applied for should be directly related to the need the life insurance was purchased to satisfy, such as to replace lost income, or cover a debt such as a mortgage or small business loan. From an underwriting point of view, insurance purchased for the following reasons is generally acceptable: ▸ Last expenses ▸ Income replacement/survivors' income ▸ Debt repayment (e.g., mortgage or college loans) ▸ Estate settlement ▸ Income in Respect of a Decedent (IRD) ▸ Business insurance While life insurance has other specialty uses such as cash value accumulation, the primary purpose must be for death benefit protection.
Income Replacement	A client's income is one of the factors looked at in determining the amount of insurance that will be granted for income replacement. An individual's total income can be comprised of earned and unearned income. Earned income can be defined as income that will normally cease upon the death of the insured, such as salaries, pensions, Social Security, and cash distributions from a business. Life insurance may be considered as a means to replace lost earned income upon the death of the insured. Unlike earned income, unearned income does not cease upon the death of the insured. Unearned income includes pure investment income and distributions from 401(k) plans and IRAs. Life insurance may be needed to cover any potential tax liability on this unearned income upon the insured's death. (Refer to the "Income in Respect of a Decedent" section of this highlighter for additional information.) Unearned income increases one's ability to pay premiums and may be available to help offset some of the financial losses the survivors may experience. However, these available proceeds may decrease the need for insurance after the potential tax liability has been taken into consideration. A software-generated income needs analysis can be useful in determining the amount of income that should generally be replaced by life insurance. Needs typically covered by income protection include mortgage protection, education needs, and providing continuing income to support dependents upon the death of the insured.

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Income Factor Tables

The following Income Factor Table is a guide to the maximum amount of insurance (excluding group coverage) which is generally acceptable in relation to the earned income of an individual with or without dependents. To use the Income Factor Table, multiply the proposed insured's earned income by the corresponding factor based on his or her age at the time of application.

AGES	INCOME		FACTOR		AMOUNT OF INS.
to 40	$	X's	35	=	$
41-50	$	X's	25	=	$
51-60	$	X's	20	=	$
61-70	$	X's	10	=	$
71-80	$	X's	5	=	$

Debt Repayment

People often purchase insurance to cover a significant debt such as a mortgage, college tuition, or a small business loan. Life insurance can be used to ensure the repayment of the debt should the insured die while the loan is still outstanding.

If no other need exists and the loan is personal, an amount equal to the loan balance is generally acceptable. This is the case for home mortgages and college loans.

For business loans, an amount of insurance equal to the non-collateralized portion of the loan, or up to 70% of the loan amount, is generally acceptable.

Income in Respect of a Decedent

Income in Respect of a Decedent (IRD) may occur at the death of the owner of assets consisting of previously untaxed money.

Although there are several types of Income in Respect of a Decedent, of particular interest is the potential tax liability of IRAs, 401(k) accounts, 403(b) funds, and other tax-deferred vehicles, including non-qualified annuities. While prudent planning may allow these assets to be directed beyond the surviving spouse, it cannot entirely eliminate the eventual tax liability.

Individuals may find that the income provided from corporate pensions, Social Security benefits, and other assets are sufficient to meet their anticipated retirement lifestyle. They may decide to transfer unneeded monies invested in a 401(k), 403(b) or in IRAs to a beneficiary upon his or her death.

If the qualified money is transferred to the surviving spouse, he or she has the option, within IRS regulations, of rolling the tax-deferred proceeds into another tax-deferred retirement account or taking a potentially taxable distribution. If the beneficiary is not the spouse, he or she may be required, within IRS guidelines, to liquidate the account at a faster rate and pay tax upon the liquidation. Retirement account balances can be substantial and the tax rate can be as high as 40%. Life insurance may be an appropriate resource to provide ready cash to pay the required income tax.

Whether or not insurance is the appropriate vehicle for this purpose should be evaluated by applying the following factors:

- Current income from pension, Social Security, and other assets utilized for daily needs are sufficient so that the IRA, 401(k), or 403(b) won't be spent down.
- Source of premium payments should come from earned or investment income or from the required minimum distribution. (**Note:** If more than the required minimum distribution will be used to fund life insurance, company "Think Twice" financing forms are always required. State-specific replacement forms may also be required.)

The amount of insurance applied for should take into consideration:

- The current value of the IRA, 401(k), 403(b), or other IRD assets.
- The current in-force insurance.

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Estate Settlement

Life insurance continues to be an effective way to provide funds for clients with larger estates to pay estate taxes. This is especially true when the estate assets are not liquid, as is often the case with ownership in family-run businesses, family farms, and when real estate is a predominant asset.

Ownership

To keep the life insurance proceeds out of the estate and prevent them from being subject to estate taxes, the life insurance policy should generally be owned by someone other than the insured, such as by the heirs or an irrevocable life insurance trust. Insured-owned policies that are later transferred to a trust are subject to a three-year lookback period. This means that the proceeds may be included in the value of the estate, and therefore, subject to estate taxes if the insured dies within the three-year period. For that reason, it is advisable that the trust be formed prior to the purchase of life insurance so that the trust can be the applicant and owner of the policy.

Amount of Insurance

All the facts of a case need to be considered when attempting to determine the amount of life insurance needed to pay estate taxes. Underwriting will look at factors such as the liquidity of the estate, the amount of the gross estate, the prospective estate value, and the timing of the life insurance purchase. The amount and type of insurance should be suitable based on a complete needs analysis. In general, an amount of life insurance equal to the estimated estate taxes is acceptable.

Projecting the Value of an Estate

For purposes of determining the appropriateness of the amount of life insurance coverage applied for, Underwriting will generally allow the value of the estate to be projected using a 6 percent growth rate for a period of 8 to 10 years. This means that life insurance can generally be applied for today, on the estimated estate taxes of the projected value of the estate at some point in the future.

Good judgment should be exercised when projecting the value of an estate. For example, a period shorter than 10 years may be more reasonable for prospective insureds age 70 or older. It may be possible to project the growth of the estate for a period longer than 10 years if the proposed insureds are younger or if second-to-die insurance is applied for.

The projected estate growth must be substantiated with acceptable documentation, which should be submitted to Underwriting with a cover letter. (Refer to the “Financial Underwriting Guidelines Highlighter,” 0211759, for underwriting considerations and information.) If documentation substantiates that the estate is growing at a rate greater than 6 percent, a higher growth rate may be acceptable for projecting the estate. This will also depend on the makeup of the estate and its actual growth rate over the past 5 to 10 years.

In general, an estate’s value should not be projected beyond 1½ to 2 times its current value. An estate projected to an amount substantially larger than its current value can result in over-insurance, which can create adverse selection and present some risk to the proposed insured and the company. In such a case, the insured’s death benefit would not reasonably represent the financial loss to the beneficiaries, but could in fact create a financial reward for all of them. In essence, the insured would be worth more dead than alive.

Unified Credit Against Estate Tax

Generally, most estates qualify for a credit against estate taxes. (**Note:** This credit is applicable if the individual is a US Citizen or a Resident Alien; however, this does not apply to Non-Resident Aliens.) This credit may be translated into an “applicable exclusion amount.” This is the amount of property that can pass to the heir’s federal estate tax-free.

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Estate Settlement *(Continued)*

In 2002, the unified credit exemption amount for estate and gift taxes was increased to $1 million, the 5% surtax was repealed, and estate and gift tax rates in excess of 50% were repealed. The table below summarizes the subsequent increases in the applicable exemption amount and decreases in the top estate and gift tax rate.

Calendar Year	Estate and GST Applicable Exemption Amount	Highest Estate and Gift Tax Rate
2006	$2 million	47%
2007	$2 million	46%
2008	$2 million	45%
2009	$3.5 million	45%
2010	Repealed	Gift tax only, equal to top individual income tax rate

With the passing of the Economic Growth and Tax Relief Reconciliation Act of 2001, estate taxes eased gradually through 2009, and then repealed for only one year, 2010. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reunified the estate and gift applicable exclusion amounts with higher exclusions and lower rates. It also provided for portability (the surviving spouse, under certain circumstances, can use any remaining amounts from a deceased spouse). Then in 2013, the previous 2001 law comes back into effect with a $1 million estate tax applicable exclusion amount and top tax rate of 55%, plus surcharge. Portability will also cease so that amounts carried over in 2011 and 2012 will no longer be available to the surviving spouse. Given the current federal deficits, it is not at all certain that Congress will act to retain these higher exclusions and lower rates. It is also not certain whether gifts made under the higher gift tax exclusion in 2011 and 2012 will be brought back into the estate tax system through what is being referred to as a "claw back."

Business Insurance

Life insurance can also be used to protect a business against the loss of a key employee or provide the funds for business continuation.

In order for a business to retain the income tax-free treatment of death benefit proceeds, the business needs to meet the notice and consent requirements of IRC Section 101(j).

Key Person Insurance

If Key Person Insurance is being applied for, Underwriting will generally accept amounts up to 5 to 10 times the key person's gross annual salary. This is generally viewed as the amount required to replace the key person. (A key person is generally a valuable employee who is not a business owner or controlling stockholder.) Amounts higher than this may be accepted in certain situations (e.g., if there is a large outstanding loan against the business, with the key person clearly the key to generating the revenues necessary to pay back the loan). Note, however, that it is unlikely that we will insure the full amount of a loan. (See the Debt Repayment section of this highlighter.)

To expedite your application, provide the following information to Underwriting to help evaluate the key employee's economic value to the business. The following information should be provided in a cover letter to Underwriting:

- The key person's current compensation
- The total compensation for the management group
- The percent of key person's compensation to total management's compensation
- The cost of replacing the key person
- His or her anticipated revenue/profit for the next 3-4 years
- The percent of revenue/profit attributed to the key person
- The individual's bio and how this strengthens the value of the "key person"

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Much of this information can be obtained from the business owner, but sometimes you will need to contact the business owner's accountant. The accountant can sometimes be an important decision maker in the purchase of business insurance. Once the business owner confirms the need and agrees on the solution, be sure to keep the accountant involved as appropriate.

Key Person Insurance in New York

New York has established regulatory standards for the issuance of key person company-owned life insurance to ensure the individuals being insured are in fact key persons and that the corporation would thus have an insurable interest in their lives. According to New York regulations, for the purposes of establishing whether there exists an insurable interest at the time a policy is issued, a person shall automatically be considered a key person if:

a) The employee is one of the five highest-paid officers of the employer.

b) An employee is 5% owner of the employer. A "5% owner" shall mean:

1. If the employer is a corporation, any person who owns or controls more than 5% of the outstanding stock of the corporation or stock possessing more than 5% of the total combined voting power or all stock of the corporation; or
2. If the employer is not a corporation, any person who owns more than 5% of the capital or profits interest in the employer.

c) The employee had compensation from the employer in excess of $90,000 in the preceding year.

d) The employee is among the highest paid 35% of all employees.

e) The employee or other person makes a significant economic contribution to the company (e.g., an employee who is responsible for management decisions, has a significant impact on sales or a special rapport with customers and creditors, possesses special skills, or would be difficult to replace).

For the purposes of satisfying (e) above, a person should be considered a key person if he or she:

- Fulfills such functions as manager, director, officer, or other such management position directing other individuals.
- Possesses special skills or talents derived by education or experience and as such would require meaningful time and expense to replace.
- Is critical to sales and revenue-generating activities and may have a proven track record in that regard.
- Has connections or relationships with key customers or accounts that would suffer without the individual's continued involvement.

If an individual satisfies (a) through (d) above, the case is acceptable from an insurable interest perspective. If it meets the criteria for (e) as qualified above, that will also be acceptable. If a case falls outside of these guidelines, and it is not clear from the application or other case development information that New York's insurable interest standards for key person coverage are satisfied, certification from the employer/corporation explaining how and why the case meets New York insurable interest standards as outlined in (a) through (e) may be required.

Buy-Sell Agreements

A buy-sell agreement is generally formed to prevent the liquidation of a business upon the death of one of the owners. Under this type of arrangement, a buyer is generally selected and a purchase price is agreed to while the business owner is living. Life insurance can generally be used to fund a buy-sell agreement. An amount equal to the liability created under the buy-sell agreement is generally acceptable.

A cover letter should include the details and status of the buy-sell agreement and who the owners are, as well as their percent of ownership, the amount of in-force and applied for insurance on all owners, and sound business financials.

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Funding a Buy-Sell Agreement with Life Insurance	A unilateral buy-sell agreement can be used when the sole owner of a business wants to sell the entire business to someone upon his or her death. Life insurance can be used to fund the buy-sell agreement. The individual purchasing the business buys life insurance on the life of the business owner in an amount equal to the value of the business. Upon the death of the business owner, the buyer receives the policy proceeds and uses the cash to purchase the business from the owner's estate. This arrangement ensures continuation of the business, allows the owner to select an appropriate successor, provides the successor with funds to purchase the business, and provides the estate with a buyer with cash to purchase the business. The buy-sell agreement also serves to set the price of the business for estate tax purposes. This is a legitimate use of life insurance and an amount equal to the value of the business is generally acceptable.
Using Life Insurance When a Family-Owned Business Is Part of the Estate	The purpose of using a unilateral buy-sell agreement is also applicable when a family-owned business is part of the estate, and the owner wishes to leave the business to only one of his or her heirs. Suppose, for example, your client, Mr. Smith, owns a family farm with a value of $1,500,000. This farm is part of his overall estate, which has a value of $3,500,000. His son, Harry, has worked with him on the farm and has contributed in large part to its success in recent years. Upon his death, Mr. Smith wants to leave the farm to his son Harry. Mr. Smith, however, has two other children, Jake and Mary. Jake is a writer and has no interest in running a farm. Mary has moved out of state to pursue a career in acting. Mr. Smith wants to treat all of his children fairly by leaving an amount equal to the value of the farm to Jake and Mary. For our example, let's suppose the estate taxes are estimated to be $1,220,000. Based on the information provided, Harry may be able to purchase insurance on Mr. Smith in an amount equal to the value of the farm. Mr. Smith may also choose to set up an irrevocable life insurance trust which will purchase insurance to cover the estimated estate taxes. Thus, the total amount of insurance purchased on Mr. Smith would equal $2,220,000. Upon Mr. Smith's death (2013), $1,220,000 of the life insurance proceeds could be used to pay the estate taxes. The $1,500,000 farm could be passed on to Harry. Harry uses the $1,000,000 in death benefit proceeds to purchase the farm from the estate. This $1,000,000, plus the remaining $2,000,000 of the estate, could be split between the two remaining children so they will all get the same amount.

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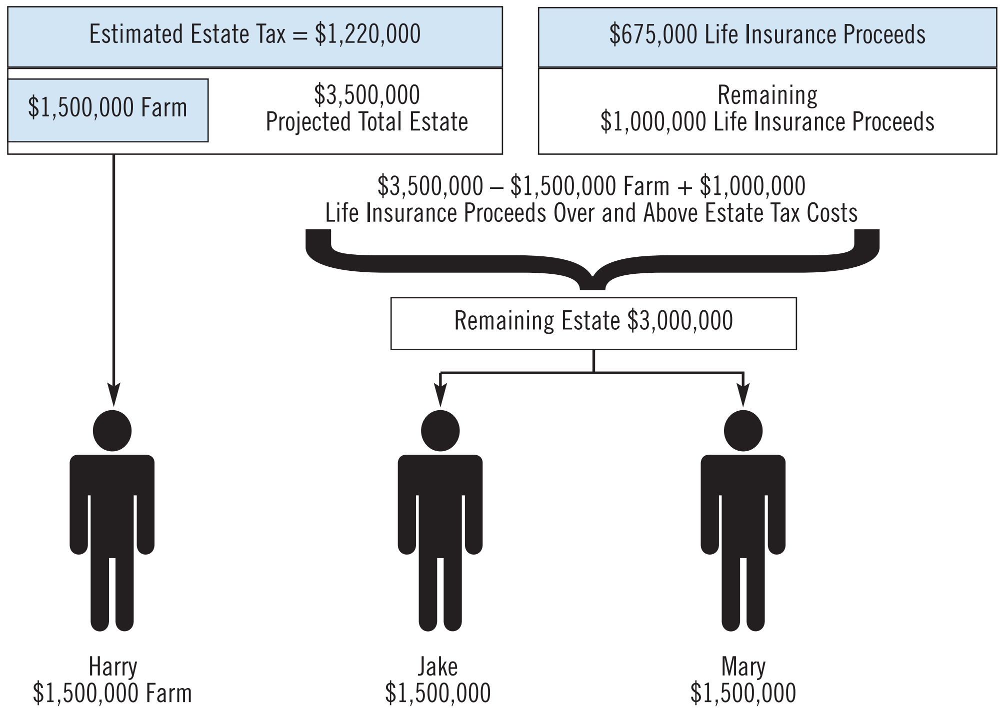
Using Life Insurance When a Family-Owned Business Is Part of the Estate *(Continued)*

This assumes Harry personally purchased the excess coverage ($1,000,000) over the estate tax needed. The estate tax portion ($1,220,000) is assumed purchased in an irrevocable life insurance trust.

Estate Divided Among Three Children



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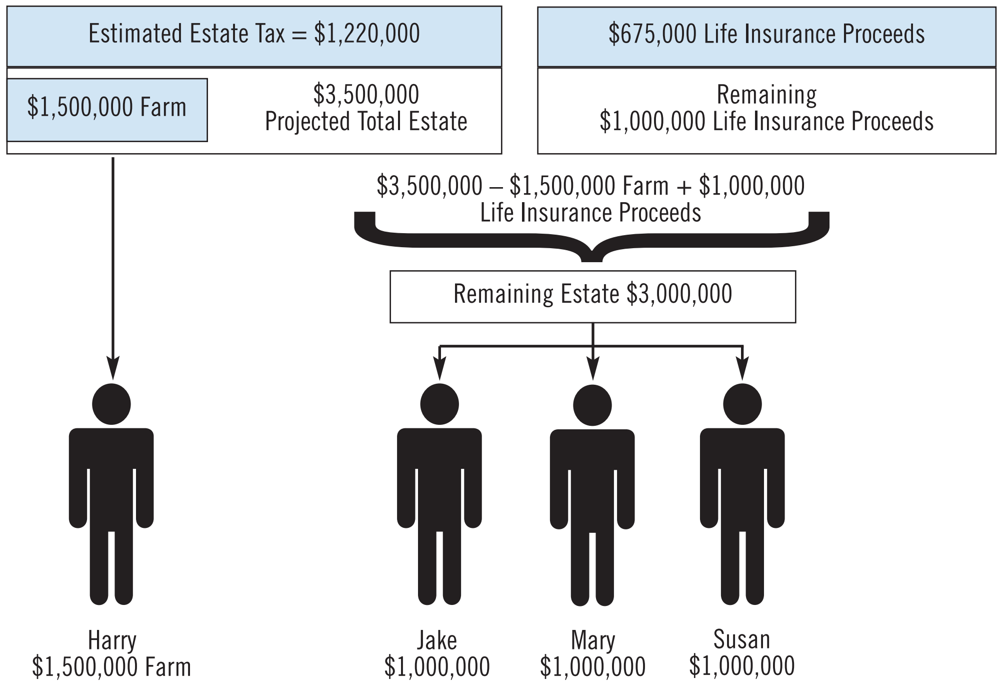
Using Life Insurance When a Family-Owned Business Is Part of the Estate *(Continued)*

This example works out evenly for all the children because of the numbers we used and the amount of children. However, this may not always be the case. For example, if Mr. Smith had four children, they would not all be left with the same amount. Harry would still get the $1,500,000 farm, but the $3,000,000 remaining would now be divided between three children, leaving $1,000,000 for each of the remaining children.

Estate Divided Among Four Children



But since cash and property are not really equivalents, Mr. Smith may be more concerned with leaving an equitable division to his children rather than an equal division. In this situation, Harry would get more than the others. An amount of insurance greater than this would generally not be approved if the sole reason was to provide all children with equal amounts.

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Sources of Information/ Documentation

In most cases, the information received during the client interview is sufficient to determine if the amount of insurance applied for is appropriate. For very large or complex cases, including estate settlement or business situations, more extensive information may be required. These cases involve higher risks and require the evaluation of more than just income and ability to pay. It may, therefore, be necessary to submit financial documents that are generally not required for smaller amounts of coverage. The type of information underwriting is looking for is that which will substantiate the amount of insurance being applied-for. The information should answer such questions as:

- What is the purpose of the insurance?
- How was the amount of the insurance applied-for determined?
- Who will be the policyowner and premium payer?
- What is the current amount of in-force and applied for insurance?

(**Note**: A Financial Supplement Form is required for all applications with face amounts of $5,000,000 or more if submitted with the new application. In addition, a Business Supplement Form is required for all insurance submitted via the new application where the purpose of the insurance is for business purposes such as buy-sell or key person coverage, or as collateral for a business loan. Submit copies of material that supplements the information requested, such as loan commitments, written buy-sell arrangements, audited financial statements, or letters.)

The proposed insured, and/or his or her advisors, attorneys, or accountants, may also be required to submit documentation to support the need for the amount of insurance requested. This documentation may include personal or business financial statements such as W-2s or tax returns, employment contracts, loan or trust agreements, buy-sell agreements, etc. It is always a good idea to inform clients, attorneys, accountants, and other financial advisors that they may be required to provide additional information. This type of financial documentation is required on face amounts of $10,000,000 or more. (**Note**: The second page of the Financial Supplement Form noted above is optional and may be completed by the third party financial advisor in lieu of independent third party financial documentation at these face amounts. This form requires the third party advisor to complete and attest to the information provided on the first page of the Supplement. Underwriting reserves the right to request additional documentation and/or financial information as needed.)

Summary

The most important source of information about a proposed insured is you. As you analyze a person's insurance needs, you gain knowledge of a potential client's worth and income. Any pertinent information should be communicated to Underwriting. It may be advisable to submit a cover letter to Underwriting that explains how the amount of insurance requested was determined. Any documentation used during this process should be included with the cover letter.

The Confidential Financial Questionnaire may be used to capture some of this financial information. The extent of this information depends on the amount of insurance you are recommending and the purpose for which it is intended.