A Basic Primer
On
Life Insurance
For
Accident and Sickness Agents
THE LIFE INSURANCE CONTRACT

A ONE SIDED CONTRACT

The Life Insurance Company irrevocably binds itself to all the terms and conditions of the contract. Referred to as unilateral. All that the policyowner has to do is to pay the premiums when due.

STANDARD PROVISIONS

The wording throughout should be both readable and legally precise, and the contract should be laid out in a form best lending itself to both simple explanation and correct interpretation.

Exemplified by the policy face page, also called the ‘schedule’ (i.e. the first page of the contract). It lists the vital particulars in three important areas.

THE BASIC PROMISE

The basic promise or commitment of the insurer is called the INSURING area. It includes:

(a) Identification of the owner and life insured.
(b) The face amount and where its payment will be made.
(c) The circumstances which will render it payable, and
(d) to whom the payment will be made.

CONSIDERATION

Stipulates premium amount and how long each payment maintains the policy in force, as well as setting the date on which future premiums are due. It also gives the premium amount for all riders added to the base policy, and the number of years for which premiums must be paid.

EXECUTION OF THE POLICY

As attested by official signatures, execution indicates that the contract has been formally made by the company’s officer and specifies the date of issue of the policy.
BASIC PROVISIONS

Provisions normally found in the contract are:

**SUICIDE**
Face Amount paid to the beneficiary after a stipulated period (normally 2 or 3 years). Prior to that time period, refund of premium.

**CONVERSION PRIVILEGE**
Convertible term and other policies with term riders allow for conversion prior to a certain age or policy year of most or all the term amount to permanent insurance. **WITHOUT EVIDENCE OF INSURABILITY.**

**AGE ADJUSTMENT**
Proof of age should be submitted by the agent prior to a death claim. This will avoid unnecessary delays when proceeds become payable. If age has been misstated, the insurance company will either increase or decrease the benefit or increase or decrease the premium.

**LOANS**
If the policyowner needs cash, but does not wish to cancel the policy, they can borrow against the cash surrender value. The company determines the interest rate at the time of the loan, but cannot exceed any maximum stipulated in the policy. If interest is not paid when due, it is added to the loan.

**PREMIUM PAYMENTS**
If premiums are not paid in accordance with the contract (i.e. annually, semi-annually, monthly), a **GRACE PERIOD** of 30 days is allowed for the payment of premiums. If the life insured does within the grace period, the amount due will be deducted from the face amount when making the settlement.

**REINSTATEMENT**
If the policy lapses through non-payment of premiums and has not been surrendered for cash, Uniform Law Insurance Law provides that the insured may apply for reinstatement of the contract within two years. To reinstate, the owner must pay the overdue premium plus any indebtedness and interest, if any, as well as furnish **EVIDENCE OF INSURABILITY** satisfactory to the company. On reinstatement there is a recommencement of the two years contestable period and suicide exclusion.
INCONTESTABILITY
The policy is incontestable after it has been in force for two years. The rationale is that after the insurance company had reasonable time to investigate the statements made by the applicant, the company should have no right to question the validity of the contract, with the exception of misstatement of age (dealt with) and fraud.

BENEFICIARY
All policies contain a clause permitting the owner to change beneficiaries.

TABLES OF NON-FORFEITURE VALUES
If the owner of a cash value policy determines that it is impossible to continue payment of premiums or no longer need life insurance, they do not forfeit their cash value, and are contractually given the following options:

1. Take the entire cash value, thereby terminating the contract.
2. Use the cash value to buy a **Reduced Paid Up Amount of Insurance**, as specified in the contract.
3. Use the cash value to buy **Extended Term Insurance** for the same face amount, for a limited period of time, as specified in the contract.
4. Take advantage of **Automatic Premium Loan** (i.e. borrow against the CSV to continue the coverage).

It should be noted that under AUTOMATIC PREMIUM LOAN, all policy riders (i.e. accidental death, disability waiver) can be maintained, whereas under extended term and reduced paid-up, no riders can be maintained. All of the cash value is used to buy an amount of reduced fully paid up insurance, or maintain the full face amount for a stipulated period of time.

OPTIONAL MODES OF SETTLEMENT
The most common form of settlement is payment of the FACE AMOUNT (Sum Insured) to the named beneficiary. However, depending on the circumstances, other settlement options exist. They include:

(i) **Interest Only** – pay interest with the right to withdraw the principal at any time.
(ii) **Fixed Amount** – payment of income for as long as it can be paid.
(iii) **Fixed Period** – payment of income for a term certain.
(iv) **Lifetime Income** – payment of a lifetime income with or without a minimum guaranteed period to the survivors.
(v) **Joint and Last Survivor Income** – income is guaranteed as long as one or the other of two people (usually husband and wife) is still living.

**ENTIRE CONTRACT**
An important provision. This tells the owner that in the absence of fraud, all statements in the application shall be held to be REPRESENTATIONS and NOT WARRANTIES. If statements are held to be warranties, then all the insurance company would have to do to break the contract is to prove that any of your statements were untrue. If statements are held to be representations (as they are in a life insurance contract), factors other than their literal truth or falseness are considered.

**MISSTATEMENT OF MATERIAL FACT**
A contract can be cancelled only if the misstatement is material to the insurance. A MATERIAL misstatement is one that will influence the insurer in accepting or rejecting the risk. As previously mentioned, the insurance company has two years from the date of issue or re-instatement (the contestable period) to cancel a contract for cause.

**Fraud** – In cases of fraud, the contract can be voided at any time. However, fraud is very difficult to prove. Fraud is the false representation of facts, made with the knowledge that it is false and without belief in the truth.

**Assignment** – A life insurance contract may be assigned (transferred) to another person or corporation by the owner. The policy provision usually sets out that the insurance company assumes no responsibility as to the validity, effect or sufficiency of any assignment, and assumes no responsibility for the assignment, unless and until it has been registered by the head office.

Two types of assignment are collateral (temporary) or absolute (permanent).

In a **Collateral Assignment** (the most common type), the policy is assigned to a bank or other lender only to the extent of an unpaid loan. However, insofar as the payment of premium is concerned, the insured is still classified as the owner of the policy and responsible for the payment of premiums.

A **Bank Assignment Form** spells out the rights of the lender and owner of the life insurance policy concerning cash, dividends, etc.
A Collateral Assignment is a temporary condition. When the loan is repaid in full, all rights to the contract revert back to the owner, whereas an Absolute Assignment is the transfer of ownership from the insured to a new owner.

An example of an absolute assignment would be a father taking out a policy on a daughter, and wants to give his daughter full and complete control of the policy 20 years later. He would do this through an Absolute Assignment (transfer of ownership) of the policy to his daughter.

POLICY RIDERS (OPTIONAL BENEFITS)

The following benefits can be added to a policy to provide better coverage.

**ACCIDENTAL DEATH BENEFIT**
A low cost rider that stipulates if death is caused by an accident, double the face amount insured will be paid provided death occurs as a direct result of the accident and death occurs within a period of 365 days.

Death by accident is generally interpreted to mean a death resulting from bodily injury affected solely through external, violent and accidental means, independently and exclusively of all other causes.

**GUARANTEED INSURABILITY OPTION (GIO)**
A rider that guarantees the life insured the ability to purchase additional amounts of life insurance at pre-determined periods in the future without having to provide evidence of insurability.

It should be noted that:

- The option to buy is seldom available more than once every other year and, in some contracts, must be exercised within a 60-day period.
- The maximum amount of each optional purchase is established when the GIO rider is arranged.
- The options to purchase may be exercised only between certain ages, such as 15 to 50.

**WAIVER OF PREMIUM**
A rider that provides that if the life insured becomes totally disabled by sickness or accident prior to a predetermined age, generally 60, and remains so disabled for three or six consecutive months, the insurer will pay all future premiums while the life insured remains totally disabled. Usually, any premium paid by the policyowner during the first three to six months of total disability is refunded.
**PARENT WAIVER**

Another type of disability clause is known as parent waiver, in the case of insurance on the lives of children. The parent waiver clause provides that, in the event of the death or total disability of the parent, or other person paying the premium, all further premiums will be waived, either for the life of the contract or until the child reaches a specified age.

**DIVIDENDS**

Dividends are credited to participating policies. It should be clearly understood that a dividend represents a refund of unused portion of the premium and the dividend credited to the insured is **NOT TAXABLE**.

Dividends are conditional upon the policyowner paying the next premium in the succeeding year. Accordingly, a dividend declared at the end of the first year would be available to the policyowner when a premium for the second year is paid.

Dividends on policies are **NOT** affected by loans on the policy, or failure to pay interest on loans.

Dividends are **NOT GUARANTEED** as they are based upon excess earnings of the company, as well as savings in mortality and operating expenses.

**DIVIDEND OPTIONS**

1. **Accumulation** – Each individual is left on deposit to accumulate at interest compounded annually. While the dividend is **NOT** taxable, any interest earned is taxable as interest income.

2. **Premium Reduction** – Each dividend is applied toward payment of the next premium due on the policy.

3. **Cash** – Each dividend is paid in cash to the applicant.

4. **Paid-Up Additions** – Each dividend is applied to purchase additional participating paid-up insurance for a level amount payable at the same time as the benefit on the basic policy.

These additions have cash value and may be surrendered at any time or used to provide non-forfeiture options or cash loans under the normal terms of the contract.
5. **Special Term Addition** – Under this option, often referred to as “the Fifth Dividend Option”, each dividend is applied to purchase an amount of one-year term insurance equal to the cash surrender value at the end of the policy year. Dividends in excess of what is required to purchase the term insurance are left to accumulate, used to reduce premium payments or to purchase paid-up additions.

This is the option which is often used in Split-Dollar Funding arrangements and in certain business life insurance situations where it is desirable that the death benefit be supplemented by a reimbursement, partly, or in full, of the total of premiums paid.

6. **Term Addition** – Each dividend is used to purchase a one-year term addition payable on the death of the insured. Under this option, the whole dividend is used to create as much additional term insurance as it will buy.

7. **Investment Fund** – Each dividend is used to purchase units in a segregated fund, which is usually strongly oriented toward common stocks. Use of this option allows an insured to combine guarantees and equities automatically under one plan.

8. **Enhanced Coverage** – Each new cash dividend is used to purchase the required amount of additional insurance called the Enhancement. The Enhancement may include the paid-up additions previously credited, if any, plus the amount of one-year term insurance needed to meet the required Enhancement for that year. Any cash dividend in excess of the amount necessary to purchase one-year term is used to purchase paid-up additions or is put into an Enhancement Reserve account.

**PREMIUM OFFSET (VANISHING PREMIUM)**

This is a method of paying premiums. It is not a dividend option, though it does involve the use of Paid-Up Additions. Under this method, future premiums are paid, or "offset" by using current and future dividends and a portion of the previously accumulated Paid-Up Additions.

After premiums have been paid for a number of years, say about 12-15 years (depending on age), the current dividend may be used to pay part of the premium. In the case where that dividend is insufficient by itself to cover the whole premium, an amount of the Paid-Up Additions is surrendered to release the cash values needed to pay the balance.
This concept, premium offset, has been responsible for much unfavourable publicity to the life insurance industry. Recognize that dividends cannot be guaranteed in future years, as the dividend is predicated on the company’s earnings in any given year. However, in the mid-eighties when company earnings were substantial, dividend illustrations presented to clients based on the companies’ high dividend rate for that particular year seemed to imply that dividends were guaranteed. In the early 90’s, earnings of most insurance companies declined, with a reduction of dividends declared. The problem that evolved was that dividend projections given to the client were based on the company dividend rates at the point of sale. When the recession began, and insurance companies’ earnings declined, dividends were reduced, resulting in policy owners who purchased participating policies, based on premiums vanishing after 10 or 12 years, having to pay the full premiums for an additional number of years. Class action suits were implemented against many insurance companies, costing those companies millions of dollars.

**RECESSION RIGHT**

10-Day period to examine policy and if not satisfied, return it to company, who will refund entire amount paid, no questions asked.
THE BENEFICIARY

Beneficiary means a person, other than the insured or his or her personal representative, to whom or whose benefit insurance money is made payable in a contract or by a declaration.

5 GENERAL CATEGORIES

A. THE INSURED’S ESTATE – While estate is not a beneficiary, nonetheless, the owner can designate his or her estate to receive insurance proceeds. Generally, it is preferable to designate a named beneficiary, but circumstances might dictate the estate (i.e. proceeds left to minor children, spouse might not be capable due to illness to handle proceeds).

Reasons for Named Beneficiary Rather than Estate

1. Minimization of costs (no probate charges, no solicitor and executor’s fees).
2. Use of settlement options rather than lump sum payment.
3. Where beneficiary named, proceeds at death might be creditor proof. Cash value of contract might be creditor proof while insured is living if member of the protected class named (i.e. spouse, child, grandchild, parent), or any person named irrevocably.
4. Payments made without complications or publicity.

Children – By Name or By Class

Example of class designation is “any child or children born or adopted of the marriage of Heather, my wife, or myself”.

Most insurance companies limit the use of class designation, if they allow it at all. The limitation is designed to protect the company against the sometimes-impossible job of locating all the members of a class.

Business Organizations

Business insurance is very popular today. Normally when a company takes out a policy on the shareholder or key employee, the company is both the owner of the policy and the beneficiary.
**Trustee**

When minor children are to receive proceeds, paid to named trustee to administer on their behalf.

**Beneficiaries and their Rights**

Under Uniform Life Insurance Law, beneficiaries may be appointed either in

1. The application for insurance (part of the contract), or by
2. A declaration (separate document or by will).

If done by declaration or by will, reference should be made to the policy number, name of company, and the full name of the beneficiary including relationship.

**Beneficiary Designations**

1. **Irrevocable** – A designation unalterable (cannot be changed) without beneficiary’s consent, the owner having given up the right to make any change in the beneficiary designation. Irrevocable designation very rarely used in common law provinces. In order to designate, the word “irrevocable” must appear in the designation.

2. **Revocable** – This is any person designated as a beneficiary but not “irrevocably”. Such designation is subject to change at any time by the owner.

3. **Estate** – The estate of the insured is not classified as a beneficiary under the law, but can be designated to receive insurance proceeds, and is subject to change at any time by the owner.

**Consequences of Irrevocable Designation**

Life Insurance policy placed beyond the control of the owner, unless the irrevocable beneficiary consents in writing to ANY CHANGE. This means that surrendering the policy for cash, borrowing on the policy, and assigning the policy cannot be done without the consent of the irrevocable beneficiary.

The policyowner may designate any person irrevocably in the application or after by a declaration filed with the Insurance Company. An irrevocable designation cannot be made in a will.
Protection Against Creditors

When the owner designates ANY PERSON as irrevocable beneficiary, the insurance money might be creditor-proof both while the insured is alive (i.e. the cash value, if any) and at death (i.e. the proceeds paid to the irrevocable beneficiary).

If a revocable designation has been made (i.e. 99.9% of designations are made this way), protection against creditors is as follows:

- If the beneficiary designation is a spouse, child, grandchild or parent, both the cash value, while the owner is alive, and the proceeds payable at death are free from claims of creditors. The spouse, child, grandchild and parents are called members of the Protected Class.

- The designation of any other person as revocable beneficiary provides no protection against the owner’s creditor(s) while the insured is alive, but when the owner dies, any insurance money payable becomes an asset of the beneficiary and thus is NOT subject to the claims of creditors.

- There is NO PROTECTION against creditors at any time when policy is payable to the ESTATE of the deceased.

- Policy proceeds in the hands of the insurer are protected against creditors both of the insured and of beneficiaries (except for necessities of life) where they are payable in NON-COMMUTABLE INSTALLMENTS.

*It should be noted that creditor protection is not available if the life insured declares bankruptcy within a period of 1 year of purchasing a life insurance policy.

Simultaneous Death

Law in all provinces provides that where the person whose life is insured and any one or more of the beneficiaries die in the same disaster, it is presumed that the beneficiary or beneficiaries died first. This means that if a contingent beneficiary had not been named, the proceeds would be paid to the insured's estate, and defeats the purpose of naming a beneficiary.

Spendthrift Provisions

In addition to protection against the creditors of the insured, provision can be made to protect beneficiaries from the claims of their own creditors. The spendthrift clause is a provision in the settlement options, which “forbids the beneficiary from assigning, anticipating, or commuting the payments coming due, and which further provides that such payments shall be free from the claims of creditors of the beneficiary and free from execution or other legal processes.
TAXATION OF LIFE INSURANCE

KEY DATE – DECEMBER 1, 1982

BEFORE

Any gain measured from the first anniversary of the policy March 31, 1977 is taxable if policy is disposed of while policy owner is alive.

AFTER

Policy classified either as

1. **Exempt** (Protection Oriented)
   OR

2. **Non-Exempt** (Investment Oriented)

I. **EXEMPT (FROM INCOME TAX)**

Characteristics of an exempt life insurance policy:

![Graph showing Accumulating Fund (CASH VALUE) with MTAR line, Issue Age, 20 Years, and Age 85]

II. **NON-EXEMPT (NOT EXEMPT FROM INCOME TAX)**

The gain in the contract is reported as income every year whether the policy owner receives the income or not (accrual method of taxation). Insurance company responsible to provide owner with T5.
TAXATION OF LIFE INSURANCE POLICIES

IMPORTANT DATES

1.  
   **March 31, 1977**
   Gain element of a life insurance policy taxed for the first time, only if policy is disposed of while alive. Gain measured effective the first policy anniversary following March 31, 1977. Any gain, which accrued prior to that date, **NOT TAXED** when disposed of.

2.  
   **December 1, 1982**
   The 1982 Federal Budget substantially changed the character of the life insurance industry. Two terms introduced:

   **EXEMPT POLICY** – A policy of life insurance protection oriented. No tax consequence unless disposed of **WHILE ALIVE**.

   **NON-EXEMPT POLICY** – Investment oriented insurance contract not exempt from income tax.

EXEMPT FROM TAXATION WHILE MAINTAINED

- Life insurance policy taken out mainly for protection in the event of death.
- Test policy – a 20-pay endowment contract maturing at age 85.
- Provided the policy remains **in force**, no Income Tax consequences.
- However, if the policy is disposed of while alive, a taxable gain could result.
- What we do is compare the Proceeds of Disposition (the Cash Value) to the Adjusted Cost Basis (ACB). The ACB in essence is the amount of premiums paid to the time of disposition, minus dividends paid on participating policies.

The gain has to be included as income and income tax paid thereon, whether received or not (accrual basis).
EXAMPLE OF NON-EXEMPT CONTRACTS:

i. Variable Deferred annuity contracts where premiums paid on a lump sum or periodic basis are invested in a segregated fund or a GIC type product (we call our Guaranteed Investment Certificates a Guaranteed Investment Annuity).

ii. Endowment contracts where premiums are paid less than 20 years or the cash surrender value exceeds that which would accumulate in a 20-pay endowment contract maturing at age 85.

iii. Certain Single Premium Whole Life contracts.

iv. Certain Universal Life policies where too much of the premiums have been directed to the savings component.

FOUR FACTORS AFFECTING TAXATION

1. **Deductibility of Premiums** – Premiums on individual policies are not tax deductible. Exception to the rule however, is when you borrow money to earn income, the Net Cost of Pure Insurance is deductible provided certain conditions are followed such as:
   
   a) The lender requests in writing that a policy be Collaterally Assigned.
   
   b) The loan was taken out to earn income.
   
   c) The amount of life insurance approximates the loan.
   
   d) It should be noted that if business or personal assets have been pledged to the lender to secure the loan, this has the effect of reducing the deduction.

   Further, it should be noted that notwithstanding the fact that a modest amount of the premium might be deductible, the face amount, sum insured is paid TAX FREE in the event of a death claim.

2. **Dividends and Interest Thereon** – Dividends are not taxable, being a reduction in the overall premium paid on a participating policy based on the company’s profitability during a given year.

   If dividends are left to accumulate however, interest earned is taxable as income.

3. **Disposition (During Lifetime)** – If a life insurance contract is disposed of by the insured while alive, income tax is eligible in the year of disposition, if the contract is protection oriented (i.e. exempt from taxation unless disposed of while alive).

4. **Proceeds Payable at Death** – Face amount is tax free at death, exception to the rule, if a life insurance contract is registered as an RRSP, proceeds taxable at death.
KEY POINT

If the insured borrows from policy to earn income (i.e. borrows $10,000 to invest in the stock market or a business for example), any interest repaid is deductible in the year it is repaid when completing income tax return.

POINTS TO CONSIDER

1. If policy was acquired prior to December 2, 1982, it is classified as a “GRAND PARENTED” policy.
2. Pre-December 2, 1982 policies are taxed under the “old” rules at disposition.
3. Life insurance policies acquired after December 1, 1982 are taxed at disposition under the “new” rules.
4. Life insurance policies classified as either exempt or non-exempt since December 2, 1982.
5. An exempt policy is only taxed at the time of disposition during the policyholder's lifetime, if in fact a disposition occurs.
6. At death, the face amount (sum insured) is paid tax-free to the designated beneficiary or estate.
7. An exempt policy is a life insurance policy that is protection oriented. An exempt policy is one where the cash values do not exceed the cash value that would accumulate in a 20-Pay Endowment contract at age 85.
8. A non-exempt policy is a life insurance policy that is investment oriented (i.e. a policy whose cash value would exceed what accumulates in a 20-Pay Endowment contract maturing at age 85).

Prime examples of non-exempt policies are Deferred Annuity contracts where capital is invested in a Segregated Fund or a Guaranteed Interest Annuity.

Any investment returns in a given taxation year has to be included as income, whether received or not. It is the responsibility of the life insurance company to send a T5 slip to the owner.
DISPOSITION

A disposition of a life insurance policy could occur under the following circumstances:

1. Policy surrender
2. Absolute Assignment
3. Maturity
4. Annuitization
5. Lapse
6. Payment of dividends
7. Policy loans
8. Disposition by law
9. Death of the policy owner (non-exempt policy only).

At disposition, what we have to compare is what the policy owner received, called Proceeds at Disposition, to what the policy owner paid, i.e. called the Adjusted Cost Basis (ACB).

ADJUSTED COST BASIS (ACB)

In its simplest form the ACB of a life insurance policy is the sum of premiums paid

LESS

a. Dividends declared on participating policies.
b. Net cost of pure insurance on policies acquired after December 1, 1982.
c. Cost of any ancillary benefits (i.e. accidental death benefit, disability waiver of premium, guaranteed insurability) on policies acquired after December 1, 1982.
d. Policy loans from the cash value of the policy, which occur after March 31, 1978.
IN SUMMARY

Policy Gain = Proceeds of disposition Minus Adjusted Cost Basis (ACB)

*Increase* in the ACB *decreases* both the policy gain and the income tax liability.

*Decreases* in the ACB *increases* both the policy gain and the income tax liability.

On policies issued after December 1, 1982, a disposition will result in a higher *policy gain* and higher *income tax liability* as the cost of pure insurance is deducted in the calculation of the ACB.

Similarly, on policies acquired prior to December 2, 1982, a disposition will result in a lower *policy gain* and lower *income tax liability*, as the cost riders are NOT excluded in the calculation of the ACB, and the net cost of pure insurance is not calculated.
# COMPARISON OF ACB CALCULATION UNDER OLD/NEW RULES

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Note that the Net Cost of Pure Insurance (NCPI) will increase each year as the policy owner grows older.

The NCPI is based on prescribed mortality tables as outlined in Regulation 308 of the Income Tax Act.

Other terms to be familiar with:

**Exemption Test Policy**

A notional life insurance policy that is deemed to exist only for the purpose of the exemption test. Its "accumulating fund" represents the real value a policy can reach without failing the exemption test.

The "accumulating fund" is a measure of the savings accumulation within the policy. In technical terms, it is equal to the "maximum tax actuarial reserve (MTAR)" for the policy.

Once the exemption test fails (if the accumulating value goes over the MTAR line), the policy becomes non-exempt, and the accrual rules will apply from that date for the life of the policy.

If a policy goes "offside" (becomes investment oriented) the insurance company and the policy owner have 60 days from the policy anniversary to correct the problem and restore the policy to "exempt" status.

If this is not done, the policy will remain classified as "non-exempt" for the balance of its existence.