PERSONAL LIFE INSURANCE PLANNING

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**Personal Life Insurance Planning  
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# About This Course

## Learning Objectives

Upon completion of this course, the student should be able to:

1. Describe the early attempt to calculate appropriate life insurance amounts known as the human life value method.
2. Understand the importance of basing client insurance requirements on a thoroughgoing analysis of needs.
3. Gather the appropriate client information required to perform an insurance needs analysis.
4. Identify and calculate a client’s family’s lump-sum needs at the death of a breadwinner.
5. Understand the Social Security survivor benefits that need to be considered in analyzing survivors’ needs for life insurance to replace income.
6. Identify and calculate survivors’ income needs during the dependency period, blackout period and retirement period.

## How You Will Learn

In this course you will be introduced to terms and concepts used in connection with personal life insurance planning. Each new term is defined in the text and included in the Glossary. The concepts are explained and, where appropriate, are demonstrated through the use of examples.

At the conclusion of each lesson, a Chapter Review is presented to test comprehension of the material presented in the chapter. A response is given to each answer you select to the questions in the Chapter Review affirming the correct choice or explaining why the choice you selected was incorrect.

## Why This Information is Important and How You Can Use It

This information is important for agents selling insurance products to customers and for advisers assessing the appropriateness of a life insurance recommendation for a client. An understanding of the methods used to determine suitable life insurance amounts to meet survivors’ lump-sum cash needs and income needs will assist the agent and adviser to better serve consumers and help ensure that appropriate life insurance amounts are recommended and purchased when they are suitable to meet client needs.

# Chapter 1 Introduction to Human Life Value & Needs Analysis

## Important Lesson Points

* Assisting individuals in determining appropriate life insurance coverage is a key aspect of the life insurance agent’s or adviser’s job.
* The human life value approach was an early attempt to approximate an insured’s life insurance requirements.
* The human life value approach relies upon two factors to determine suitable life insurance coverage: earning capacity and dependency.
* The human life value approach to determining life insurance coverage amounts has serious flaws, the most significant flaw being its lack of relationship to actual needs.
* Insurance needs analysis provides the life insurance agent and insured with a realistic and meaningful assessment of an individual’s life insurance requirements.

## Chapter Learning Objectives

In this chapter we will look at the principal early attempt to determine appropriate life insurance amounts to meet personal life insurance needs. When you have completed this chapter you should be able to describe how the human life value method approximates individual and family life insurance requirements.

## Determining Insurance Amounts — Human Life Value

The determination of how much life insurance is appropriate for any individual insured is an important part of an agent’s and an adviser’s professional role. To understand where we are in meeting that important function, however, we need to understand the earlier attempts to determine suitable life insurance amounts. In a sense, we need to consider where we were.

An important name in the earlier attempts to determine appropriate life insurance amounts is Dr. Solomon S. Huebner—a former professor at the University of Pennsylvania. He is credited with developing one of the first systems for determining how much life insurance is appropriate, based on the economic value of a human life—appropriately called the “Human Life Value” approach.

The human life value approach to determining the appropriate amount of life insurance involves the estimating of an individual’s personal earnings each year to retirement, from which the costs of self-maintenance, life insurance premiums and income taxes are deducted to produce residual income. The residual income stream is then discounted to its present value. The present value of that residual income stream is the value of that human life as determined by the human life value approach.

Although any individual life may have many different values to society or to other individuals—for example, that life may produce great art like that created by Michelangelo—life insurance is really concerned with the economic value of a human life. That economic value results from two factors:

1. The individual’s earning capacity and
2. Other people being dependent upon that individual’s earning capacity.

As we can see, it isn’t someone’s earning capacity alone that creates an economic value which serves as the basis of life insurance. Not only must the individual have an earning capacity, that capacity must be relied upon by others.

There are some obvious relationships in which we would be likely to encounter both of those factors—earning capacity and dependence. Specifically, in both families and businesses we find an individual’s earning capacity that is relied upon by others.

Most reasonable people would probably agree that an individual should protect his or her earning capacity for the benefit of dependents by owning the appropriate amount of life insurance. The problem is in how to determine just what is appropriate. In other words, how do we measure that economic value?

We noted that this early system applied a value to a human life by using the method known as the human life value approach. In order to better understand the importance of needs analysis, we should appreciate this earlier system. However, before we begin to look at the actual calculation of the life insurance need under the human life value approach, we need to realize that it is based on the idea that a person should own an amount of life insurance equal to the capitalized value of his or her net earnings.

### Capitalized Value of Net Earnings

How much capital would be needed to replace earnings? It is an amount equal to the present value of that stream of net earnings.

Capitalizing the value of an individual’s net earnings requires five steps:

1. Estimate average annual earnings over the individual’s working lifetime
2. Deduct taxes, insurance premiums & self-maintenance costs
3. Determine number of years until retirement
4. Decide on appropriate discount rate
5. Calculate:

(1-2) x Present Value of $1[based on 3 & 4] = Human Life Value

Let’s briefly examine each of these steps.

In the first step, you need to estimate the individual’s average annual earnings from personal efforts over the remaining years of his or her income-producing lifetime. That is, until the person’s retirement date.

There are certain rules of thumb that can assist in making this calculation. In order to estimate the individual’s average annual earnings, you need to factor in the following facts. Historically:

* Semiskilled and clerical workers reach their maximum annual earnings at about age 40;
* Professional workers reach their maximum annual earnings at about age 55; and
* Certain other workers, such as entrepreneurs, reach their maximum annual earnings just before retirement.

In the second step of the human life value calculation, the agent deducts from the prospect’s annual average earnings the:

* Federal and state income taxes,
* Individual’s life insurance premiums and
* Costs to maintain the person.

By deducting these amounts from the average annual earnings, the human life value approach arrives at the earnings used to support the individual’s family. There is a difference in the percentage of earnings used to support a family for a high-income earner compared to a low-income earner.

Since a high-income earner is likely to have greater discretionary income than a low-income earner, proportionately less of his or her earnings are likely to be used to support a family. In addition, more of those earnings are used to pay taxes and to maintain the individual. For example, a professional worker may routinely purchase a $1,000 suit of clothing while the low-income earner may consider such a purchase extravagant and purchase a less expensive suit.

A general rule of thumb is that about 2/3rds of lower-income earners’ income is devoted to maintaining a family while 1/2 or less of high-income earners’ income goes towards family maintenance. Remember this relationship, because we will be using it later in this course.

In step three, we need to determine how long a family can expect to receive the worker’s income. For most families, that means until the worker’s retirement at, let’s assume, age 65.

In the fourth step, we will determine the rate of interest to use in discounting those future earnings to derive a present value. The present value is the current value of a future sum discounted at some interest rate, also known as a discount rate. The discount rate used in determining present value is the annual rate of return that could be earned currently on an investment. Since life insurance companies are appropriately conservative in their assumptions, the rate of interest chosen as the discount rate should approximate the rate of interest generally payable on proceeds left with the company. Another rate that you may want to use is the current passbook savings account rate.

In the fifth step, we will be using the information that resulted from the first four steps of the human life value calculation to determine this individual’s human life value. In other words, we will be calculating the present value of the future stream of net income that our client would produce for his family if he were to continue working until his retirement.

That is the amount that would need to be provided in death benefits under this system of determining life insurance requirements.

## Human Life Value Case Study

Let’s take a couple of minutes to determine the human life value of Bill Jones, i.e. the amount of life insurance that he should own. Bill is married with two children. He is a 35 year-old truck driver earning $40,000 yearly. For purposes of this exercise, let’s assume Bill will retire at age 65, will have had average annual earnings since age 35 of $50,000 and that the current passbook savings rate is 5%. In order to find the answer for Bill and his family, you will need to use either a financial calculator or a compound discount table. (A compound discount table is a table that enables you to calculate the present value of money payable in the future[[1]](#footnote-1).) A compound discount table to determine the present value of $1 annuity is included in Appendix A.

|  |
| --- |
| Bill Jones’ Family and Income Situation |
| Age — 35  Family status — Married, two children  Occupation — Truck driver  Current annual income — $40,000  Average earnings to retirement — $50,000  Retirement age — 65  Current passbook savings account rate — 5% |

### Bill Jones’ Life Insurance Need — Human Life Value Approach

In estimating Bill Jones’ life insurance need using the human life value approach, his average annual income to retirement is estimated. In this case, it is estimated at $50,000. At Bill’s current income of $40,000, it is likely that 2/3rds of his income is used to maintain his family. So, the family’s claim on the average family income is $33,333. The task is to determine the present value of that 30 years of family maintenance that the family would lose if Bill were to die today. Since the current passbook savings account is 5%, we can determine the present value at 5% of that stream of income over the next 30 years by using the following formula:

($50,000 X .66666) X 15.3725 = $512,412

1. $50,000 X .66666 is 2/3rds of Bill’s average income to retirement that will probably be spent maintaining his family.
2. 15.3725 is the factor to use to determine the present value of a stream of income payments stretching over 30 years at a discount rate of 5%.
3. Bill’s human life value is calculated to be $512,412

## Human Life Value Limitations

We have just calculated Bill Jones’ human life value. Do you feel comfortable that the amount you calculated represents the amount of life insurance that Bill’s family needs to maintain its current living standard? If you have some sense that the one-size-fits-all approach that we used may leave a lot to be desired, you are right.

Let’s provide some additional facts about Bill that illustrate why this approach may fail. What we didn’t realize at the time that we calculated Bill’s insurance amount using the human life value approach was that Bill and his wife, Pat, have just purchased a new house on which they have a $200,000 mortgage. Pat is just finishing law school, and they bought the larger house so that Bill’s aged parents, whom they are supporting, could move in with them. Notice how this additional information makes us suspect the validity of our earlier calculation of Bill’s life insurance needs?

Bill and his family’s life insurance needs don’t seem to fit as neatly into our calculation as they did before. This points up one of the serious concerns with the human life value approach to calculating life insurance needs. It’s a “one-size-fits-all” method. And, one thing that we know about families’ financial status is that they can be quite different from one another.

The other problem with the human life value approach is that, as the individual becomes older, his or her human life value declines since there are fewer income-producing years remaining.

The biggest problem, of course, is that the human life value approach calculated something as important as the funds needed to ensure a family’s future without regard to the family’s actual needs.

The Insurance needs analysis approach that we will be discussing overcomes the serious limitations of this one-size-fits-all formula of the human life value method.

## Determining Insurance Amounts — Advantages of Insurance Needs Analysis

The Insurance needs analysis approach to calculating life insurance needs is:

* More realistic than the human life value approach because it deals with specific needs;
* Sensitive to the financial differences between families; and
* More likely to be meaningful to individuals and their families.

Let’s turn our attention now to insurance needs analysis, beginning with gathering client information.

## Summary

The human life value approach to the determination of life insurance requirements represented an early attempt to assign a particular life insurance amount to an individual’s situation, based on his or her earning capacity and existence of dependents. Although the approach is relatively simple, it has serious deficiencies. Its primary flaw is that it has little or no relationship to the individual’s needs.

Insurance needs analysis overcomes the limitations of the human life value approach by basing the determination of insurance requirements on the actual life insurance needs of the customer.

## Test Your Comprehension

1. John is a 40 year-old married client with two young children whose current annual earnings are $50,000. Of that annual wage, his total state and federal income taxes amount to $5,000, his annual life insurance premiums are $600, and he believes that his self-maintenance costs are about $100 weekly. He expects that over his remaining working life he will have average annual earnings of about $60,000. If he expects to retire at age 65 and current passbook interest rates are about 3%, what is his approximate economic value under the human life value method? (Use the present value factor for a $1 annuity shown in the excerpt below)

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Annuity | | | | | | | |
| Years | 2% | 3% | 4% | 5% | 6% | 7% | 8% |
| 20  25  30  40 | 16.3514  19.5235  22.3965  27.3555 | 14.8775  17.4131  19.6004  23.1148 | 13.5903  15.6221  17.2920  19.7928 | 12.4622  14.0939  15.3725  17.1591 | 11.4699  12.7834  13.7648  15.0463 | 10.5940  11.6536  12.4090  13.3317 | 9.8181  10.6748  11.2578  11.9246 |

1. $944,739
2. $839,311
3. $929,860
4. $1,205,000

2. The human life value method of calculating an individual’s life insurance need has been criticized as being flawed. Which of the following is NOT an identified flaw of the human life value method?

1. It uses a one-size-fits-all approach to calculating needs for families whose actual needs may vary
2. An individual’s life insurance need is shown as declining under the human life value method as he or she ages, even if the actual need increases
3. The human life value method calculates a personal life insurance need for individuals who have no dependents
4. The human life value method determines a life insurance need without reference to the individual’s actual needs

3. Which of the following is characteristic of the insurance needs analysis method of determining an individual’s life insurance needs?

1. It is more realistic than the human life value method
2. By employing a formula approach to the calculation of life insurance needs, it generally disregards the financial differences between families
3. It relies on averages of the amount of earnings allocated to ensuring family lifestyle
4. Despite its use of specific individual and family financial needs, it tends to be somewhat less meaningful to individuals and their families

# Chapter 2 Gathering Client Information for Needs Analysis

## Important Lesson Points

* Understanding the individual’s life insurance needs using the insurance needs analysis method requires that the agent know the individual.
* The data-gathering interview is considered by many agents to be the most important client meeting in the sales process.
* The five principal areas in which data-gathering must be accomplished are income, assets, liabilities, goals and risk tolerance.
* Obtaining the needed information from prospects requires that the agent build rapport and create trust.
* The most effective information gathering involves the agent’s understanding of both the facts and their emotional content.

## Chapter Learning Objectives

In this chapter we will look at the requirements and importance of gathering specific data in the personal life insurance planning process.

When you have completed this chapter you should be able to:

* Identify the types of customer information needed to determine appropriate life insurance needs; and
* Explain why information concerning a customer’s financial situation, objectives and risk tolerance is necessary to the personal life insurance planning process.

## Required Data

In order to calculate an individual’s life insurance needs using the human life value method, you really did not need to know very much about the individual. That, of course, is the source of its major weakness. To understand the individual’s life insurance needs using the insurance needs analysis method, you must know the individual. Let’s spend some time learning how to do that, and we will begin with data-gathering.

If you want to know your prospect, there is no substitute for a thoroughgoing fact-finding interview. Agents generally agree that this interview is the most important one in the sales process. Knowing just what information is required about our prospect in order to analyze his or her insurance needs is where we will begin our focus in a discussion on needs analysis.

There are five principal areas in which an agent needs to understand the prospect. In order to know your prospect, you need to know his or her:

* Current income
* Goals and objectives
* Accumulated assets
* Risk profile
* Current liabilities

Only by knowing these facts about your prospect can you hope to be able to make a suitable life insurance recommendation.

### Current Income

Knowing that we need something is quite different from knowing why it is needed. Let’s examine why we need to know each of these different pieces of information. We will begin with the prospect’s current income.

An important objective of life insurance planning is to ensure that survivors are able to maintain their standard of living despite the death of a breadwinner. Most families live primarily on their earned income, rather than on their assets. In order for the surviving members of the family to continue to enjoy the standard of living that they had before the prospect’s death, they will need to have that income replaced, so it’s critical that we know what that income is.

An important concept to remember when dealing with family finances is this:

*A luxury once enjoyed quickly becomes a necessity.*

For example, a family whose children have always attended the finest prep schools would consider such attendance not to be a luxury. For them, it would be a necessity. For that reason, the needed income replacement level varies between families. Some families may need 50 percent of a breadwinner’s income to keep their standard of living, while others may need 75 percent or more

### Accumulated Assets

The second piece of information that we noted is the prospect’s accumulated assets. There are three principal reasons why it’s important to determine the amount of the prospect’s assets.

The first reason is that the prospect’s liquid assets can reduce the amount of life insurance that may be needed. If $250,000 is required to replace the prospect’s income, and he or she has already accumulated $50,000 in savings or investments, only $200,000 of life insurance may be necessary.

The second reason for the agent’s need to be informed about a prospect’s assets is that the assets owned by the prospect at death become a part of his or her estate for tax purposes. Depending upon the size of those assets, estate settlement costs and taxes approaching 40 percent may be due within 9 months of death—thereby increasing the prospect’s life insurance need. Estate settlement costs are those costs associated with the settlement of a decedent’s estate. They include executors’, attorneys’ and appraisers’ fees and other expenses. In addition, estate taxes may be payable, depending on the value of the decedent’s assets. Generally, estate taxes are not imposed until the taxable estate exceeds a certain amount, generally referred to as the “applicable exclusion amount” or “exemption equivalent of the unified estate tax credit.” Life insurance is often the most cost-effective method of paying those costs.

The third reason for needing to know the extent of a prospect’s assets is that the prospect’s assets may be the only viable source of life insurance premium payments—especially when the life insurance need is large. It is not unusual for a wealthy client to employ a strategy of making annual gifts of existing assets to both reduce the taxable estate and to pay life insurance premiums on life insurance owned by a trust or adult children.

### Liabilities

The next category of information that we need to determine about our prospect is his or her level of liabilities. The reason for that may be obvious, but let’s examine it.

The prospect’s liabilities don’t die when the prospect dies. They become the liabilities of the prospect’s estate and may drain the assets that might otherwise be available for the surviving family members. Paying any liabilities that remain upon the prospect’s death by using life insurance may be important to the prospect.

One of the most substantial liabilities that many people have—and which they often want to pay off—upon their death is a primary mortgage. Although certainly not the only liability that prospects have, the mortgage on the family’s home is one that many prospects are concerned about.

Other liabilities that the agent needs to know about include:

* Credit card debt
* Bank loans
* Education debt
* Second mortgages

### Goals and Objectives

The agent also needs to learn about the prospect’s goals and objectives. Typical family financial goals might include:

* Assuring an adequate income to the family survivors
* Educating children
* Providing a secure retirement

Families may have many goals, of course. The agent needs to be aware of them because they can have an enormous impact on a family’s need for life insurance.

### Risk Profile

Finally, the agent needs to have a sense of the prospect’s risk profile. In other words, we need to know how tolerant our prospect is of risk. A prospect’s risk tolerance level is important more for determining the *type* of life insurance to recommend—whole life, universal life or variable life—rather than the amount of death benefit. Those with a low risk tolerance are probably more likely candidates for traditional whole life or universal life insurance with guarantees for certain minimum death benefits and cash value accumulations. Those with a higher risk tolerance and a willingness to accept increased risk in return for a potentially higher rate of cash value growth may be more interested in variable life insurance.

## Building Rapport and Creating Trust

As we can see, the agent needs to know a lot about the prospect before he or she can do the right job. Obtaining this data requires considerable prospect candor and willingness to provide the information. Not all prospects, however, are immediately willing to open up to an agent. Often the agent must build rapport with and create trust in the prospect.

Some prospects are willing to share this information with the agent. In fact, they may be almost eager to share it. Others, however, may be far more reluctant. Whether or not a prospect is willing to share personal financial information with an agent often depends on the level of trust the prospect has and the rapport that the agent has developed with him or her.

Generally, we tend to trust people that we perceive have the same values that we have. When we meet somebody who shares our values, we may have a feeling of instant rapport. What is really happening is that we are internally acknowledging that this is somebody who is like we are. We feel comfortable around him or her, and we mentally unfold our arms.

That’s what happens and why prospects may be willing to share information with us that they wouldn’t consider sharing with anyone else. Now that we know that trust and rapport must precede any data-gathering efforts, let’s move on to the more challenging issue. How do we develop that rapport and create that trust with prospects?

Many people have an intuitive sense that enables them to build rapport in a social situation. For many, building rapport in the business situation, however, is far more challenging. Fortunately, there are techniques that an individual can learn and master that will help to build rapport.

Everyone has probably heard about the mythical salesman that could talk his prospects into buying almost anything. The fact is that you can almost never talk a prospect into buying. However, you can listen him into it. This is the first important element in building rapport.

In order to build rapport, the agent needs to ask non-threatening, open-ended questions that draw out prospect wants and needs. Let’s examine that statement.

Consider a question like:

*“Do you really care about your family?”*

A question like that one is, clearly, a threatening question. By asking it, the agent is calling into question the prospect’s sense of caring and responsibility. Such a question tears down rapport.

Not only should the agent ask non-threatening questions of the prospect, the questions should also be open-ended. The best way to define an open-ended question is to see it as a question that can’t be answered by a “yes” or “no.”

Open-ended questions are questions that usually ask:

* How
* Who
* Why
* What

So, when we ask a non-threatening open-ended question that draws out our prospect’s wants and needs, we are asking one that:

* Doesn’t challenge the way the prospect perceives himself or herself;
* Must be answered by saying more than just “yes” or “no”; and
* Focuses on what the prospect wants or needs for his or her family.

When we think about non-threatening, open-ended questions that draw out wants and needs, we generally mean questions that begin with who, what, how, or when and ask about things that are or may be important to the prospect. Examples of questions that do this are:

* “How do you feel about educating your children?”
* “How important is it to you that your family be able to continue to live in their home when you die?”

**Note:** These questions are simply examples. There are many other questions that the skilled agent will ask.

As we can see, these are questions that encourage the prospect to talk about things that he or she considers important. However, not only do we need to ask the prospect questions that allow him or her to disclose feelings, we need to respond to that disclosure. In other words, we need to employ responsive listening techniques.

### Responsive Listening

Responsive listening requires that you, as the listener, respond to the person who is speaking. This response usually takes the form of:

* Nodding approval
* Verbalizing agreement by saying “I understand how you feel”
* Paraphrasing the prospect’s statements

The important element in responsive listening is that the speaker—your prospect, in this case—believes that you and he are on the same wavelength and that you feel about things in much the same way as he does.

### Establishing Credibility

Remember, what we are trying to do is to develop rapport. Establishing your credibility is an important element in developing the trust necessary for rapport. If you are not professionally believable—that’s the essence of credibility—you are not likely to gain your prospect’s trust.

Your professional credibility is established and enhanced by your doing those things that demonstrate you can be believed. For example:

* If you don’t know the answer to a question the prospect asks say that you don’t know but will research it.
* Focus solely on the prospect’s needs—without regard to any reward that you might obtain. A “service-before-income” outlook is a hallmark of the professional.

Other things that will enhance your credibility include:

* Obtaining professional credentials—CLU, ChFC, CFP and others. They won’t guarantee that you will know all of the answers, but they demonstrate that you care enough about your profession to spend the time, money and effort to learn about it.
* Becoming involved and participating in the various professional organizations, such as the Estate Planning Council.
* Writing articles dealing with insurance matters and the meeting of client needs.

Finally, you need to demonstrate your competence. You do that by:

* Doing what you promise;
* Following-up to ensure that everything is done—wills are drawn, trusts are established, etc;

When you have created the rapport with your prospect so that he or she is willing to disclose important financial details, you still need to obtain the information. Let’s turn our attention to how you can do that most effectively.

## Effective Information Gathering

You remember the Dragnet character of several decades ago that wanted “Just the facts ma’am.” Unlike sergeant Friday, who uttered those famous words, our job is not only to get the facts, it’s to get the facts behind the facts. In other words, we need to understand what the prospect means, which may require more than just listening to what he or she says.

Let’s consider an example. When you ask your teenager how he or she is, and the response is “fine,” that response can mean anything from “Everything is really great” to “It’s none of your business” or “My life is a mess.” The difference in meaning may depend upon how your teenager says it.

The emotional content of language adds richness and additional meaning to what people say. Much of that emotional content is contained in the delivery. This is as true for your prospect as it is for your teenager. We need to listen not only to what our prospects say but also to how they say it. In other words, we need to be sensitive to the prospect’s attitudes and emotions since they add a great deal of meaning to what he or she says.

Those attitudes and emotions are evident in how words are delivered, of course. They are also evident in other ways, however, such as in body language. The way a prospect sits, stands, gestures or uses his or her body speaks volumes about the emotional content of the words he or she is using. Let’s consider some of the more obvious examples.

Words spoken in a normal tone while the speaker is standing over you with his fists clenched have quite a different emotional content than the same words spoken while the speaker is sitting, relaxed, in an easy chair.

What about the prospect that answers your data-gathering questions with his arms folded across his chest? Although it could have no emotional content at all and may simply mean that he or she is cold, it may mean something quite different.

What might that kind of body language mean? Your prospect’s arms folded across his chest may mean that the prospect is emotionally detached or uninterested in what you have to say.

Effective communication requires, in the first place, that you have a good understanding of what your prospect is telling you—both its:

* Factual content and
* Emotional content

That emotional content may tell you how important the subject is to your prospect.

You also need to assess the meaning of the words by how they are delivered.

* Is the language loud or soft?
* Are the words delivered with staccato-like speed or more slowly?
* Does the prospect’s body language show anger, impatience, sadness or concern?
* Is the prospect engaged in the process or just waiting until you are finished before doing something that she finds more important?

You will work with your prospect most effectively if you assume the role of a counselor. Your job, as a counselor, is to:

* Help your prospect identify important financial needs and wants and
* Recommend the proper amounts and types of life insurance to satisfy those needs and wants

Selling life insurance, however, is different than selling many other products. The difference has to do with impact. For example, if your prospect is thinking of buying a new car, it probably isn’t going to affect his or his family’s life significantly if he buys it or not. Life insurance is different. The decision to buy—or not buy—life insurance may affect your prospect’s family’s life and the life of generations not yet born in incredibly significant ways.

It may mean the difference:

* Between opportunity and lack of opportunity
* Between education and ignorance
* Between a family that remains together and one that is torn apart

Life insurance is far more than a contract containing words on paper. It’s educations; it’s a parent being able to remain at home to raise children; it’s freedom from financial worry for an aging widow.

The best and most effective life insurance salespeople share their vision of life insurance with their clients. To have the prospect share your vision of the importance of life insurance requires that you connect emotionally with him or her. Without that emotional connection, the true value of life insurance may never be appreciated.

It will help you in connecting emotionally by giving feedback to your prospect. Nod your approval, as appropriate. Verbalize your agreement by saying something like “I understand how you feel.” Paraphrase your prospect’s responses. Not only does this enable you to build rapport, it allows you to check your understanding of the prospect’s statements.

Finally, it is vital that you focus intently on your prospect’s needs. Take them seriously. Remember that, if you don’t consider your job of taking care of the prospect’s financial needs to be important, he or she may not consider it important either.

## Summary

This lesson examined how understanding the individual’s life insurance needs using the insurance needs analysis method requires that the agent know the individual. It discussed the data-gathering interview, which is considered by many agents to be the most important client meeting in the sales process.

It focused on the five principal areas in which data-gathering must be accomplished—income, assets, liabilities, goals and risk tolerance—and how obtaining the needed information from prospects requires that the agent build rapport and create trust. Finally, it explained why the most effective information gathering involves the agent’s understanding of both the facts and their emotional content.

## Test Your Comprehension

1. Which of the following types of customer information is NOT required in order to recommend an appropriate amount of life insurance?
2. current income
3. risk tolerance
4. assets and liabilities
5. goals and objectives
6. Why is it important to know a personal life insurance prospect’s current income?
   1. Only individuals earning more than a specified minimum amount may purchase certain types of life insurance.
   2. One of the important functions of life insurance in a family situation is to help replace an insured’s current income.
   3. For statistical purposes to be able to segment insureds appropriately.
   4. To determine how much premium the prospect can afford to pay.
7. Which of the following is NOT a reason why information about the prospect’s accumulated assets is required to determine the amount of life insurance needed?
8. Existing liquid assets reduce the amount of needed life insurance.
9. Large amounts of accumulated assets may increase the need for life insurance.
10. Existing assets may provide needed premium funds.
11. The amount of life insurance an insurer will issue is limited by the amount of an applicant’s assets.

# Chapter 3 Identifying and Calculating Lump-Sum Financial Needs at Death

## Important Lesson Points

* Lump-sum survivor needs often include the need for immediate cash to pay last expenses, liquidate consumer debt, provide a fund for emergencies, redeem a mortgage, provide dependent care and pay for education.
* Seventy percent of a prospect’s lifetime medical expenses are often incurred in battling a final illness.
* A single month’s survivor income should be provided as a cash need in order to meet expenses while ongoing income arrangements are being made.
* A general guideline for estimating immediate cash needs is 30 – 50 percent of the family’s gross income.
* A family’s debts don’t die when the breadwinner dies. They are passed down to the survivors.
* Establishing an emergency fund for survivors helps provide some of the financial flexibility that is lost following the death of the breadwinner.
* A general guideline for estimating emergency fund needs is 6 months of current gross income.
* Providing a fund for mortgage redemption should not require that the mortgage be redeemed. Rather, it should give the survivors the option to redeem it.
* Dependents may include not only minor children but also aged parents and dependent siblings.
* When establishing an education fund, the education needs of the surviving spouse should be considered as well as the education needs of children.

## Chapter Learning Objectives

In this chapter we will look at the process of identifying and calculating lump-sum financial needs at a breadwinner’s death.

When you have completed this chapter you should be able to:

* Identify the principal lump-sum family financial needs following a breadwinner’s death;
* List the immediate cash needs generally experienced by surviving members of a deceased breadwinner’s family;
* Describe the principal estate administration costs; and
* List the primary uses of an emergency fund for surviving family members.

## Lump-Sum Cash Needs

Let’s turn our attention, now, to the needs that individuals and families have. We will begin by considering the lump-sum needs that a family may have at the death of a breadwinner.

Some of the important lump-sum cash needs that a family will have when a breadwinner dies may include all of the following:

* Immediate cash needs (burial, final medical, etc.)
* Mortgage redemption/rent fund
* Consumer debt liquidation
* Dependent care
* Emergency fund
* Education

The first lump-sum cash need we noted was for immediate cash needs. Some of the immediate cash needs a widow or widower might have upon the death of the family’s breadwinner include:

* Funeral and burial expenses
* Federal estate taxes
* Unreimbursed medical and hospital expenses
* State death taxes
* Costs of estate administration
* One month of survivor’s income

### Burial & Final Medical Expenses

Dying is a costly business, and the funds needed to pay for it can be substantial. In addition to the costs of burial and funeral—which may be $5,000 to $12,000 for an average funeral to much more for a lavish one—there are the final medical and hospital expenses.

Often as much as 70 percent of an individual’s lifetime medical expenses are incurred in a final illness. While it is impossible to determine exactly how much will not be reimbursed by insurance, it is important for the prospect to consider this cost in his or her insurance planning.

### Estate Administration Costs

The next category of lump-sum cash needs that we noted is “estate administration costs.” The three significant estate administration costs for many families are usually the:

* Probate court costs,
* Fees required by attorneys hired by the estate and
* Executor’s fees.

Probate court costs are those costs incurred by the court—generally known as the probate or surrogate’s court—in supervising the management of a decedent’s estate, paying its debts and its distribution of any remaining assets. The executor or administrator is responsible for making the day-to-day decisions incident to estate administration. Such decisions may involve the decision to sell assets, obtain appraisals, etc. In performing these tasks, the estate executor or administrator may hire attorneys, accountants or other professionals to handle particular functions.

For some larger estates, however, the most significant costs are federal estate tax costs.

### Federal & State Taxes

A detailed examination of the federal estate tax system is necessary for a complete understanding of it. For now, it is important to be aware that the estate of anyone dying with assets exceeding the Applicable Exclusion Amount—the amount that may be passed estate tax-free—and without an eligible spouse to whom to leave it will incur federal estate taxes.

Depending on the extent of the decedent’s estate, federal estate taxes may approach 40 percent or more of the value of the estate and are generally due in cash nine months after the date of death. In addition to federal estate taxes, many states also levy inheritance or estate taxes.

### One Month’s Current Income

Finally, in the category of Immediate Cash Needs, the prospect should provide at least one month’s current income. That will be needed by the surviving spouse during the first month following the breadwinner’s death until arrangements are made to provide an ongoing survivor income.

Unless your prospect has assets that will result in the imposition of federal estate taxes, the amount that should be allocated for Immediate Cash Needs is generally 30%—50% of the prospect’s current gross annual income. For some prospects, of course, this will be more than is needed, for others it will not be enough. It is important to review the possible costs with the prospect, suggest a range of appropriate amounts and let the prospect decide how much of an immediate cash fund should be provided.

## Consumer Debt Liquidation

The next major category of immediate lump-sum cash needs is debt liquidation. Those debts don’t die with your prospect. They become the liability of his or her family, and it is usually important to reduce the family’s debt load upon the death of a breadwinner because the family’s income is reduced.

Even with both spouses contributing an income to meet family expenses, the loss of one of those incomes can result in severe hardship — and Americans are in more debt than ever before.

The debts that most families have often include:

* Credit card balances
* Auto loans
* Unpaid notes
* School loans

When the prospect’s debt liquidation needs are calculated, you should add up all of the current balances for each of these debts and then add one month’s normal household bills, such as electricity, telephone, rent or mortgage, etc. The total arrived at is the amount that normally should be allocated to retire the family’s consumer debt.

## Emergency Fund

Next in the category of lump-sum cash needs that we noted was an emergency fund. When you think of an emergency fund, you need to see it as a bucket of money that is designed to help replace the financial flexibility that the family had when the breadwinner was alive. It is often used to pay for major medical emergencies and to make large repairs or replace major items.

In addition to medical emergencies the following large repairs or replacements are usually considered in determining the proper size emergency fund:

* Home repairs
* Major appliance replacement
* Automobile repairs or replacement

The Emergency Fund is normally used to pay for medical emergencies or to make major repairs to or replacement of the survivors’ house, cars and major appliances, like:

* Television sets
* Refrigerators and
* Dishwashers

As a general guideline, many financial practitioners use six months income as a target for emergency funds.

## Mortgage Redemption or Rental Payment Fund

For many families, their home represents their largest investment—both financially and emotionally. For that reason, families often want their survivors to have the option of remaining in their own home if they wish. Having that option usually means having sufficient funds to redeem the mortgage.

Determining the amount of the mortgage fund needed is a simple matter. Just determine the current outstanding mortgage loan principal balance. That should be your mortgage fund. If the prospect does not know the outstanding principal balance, just look at the annual mortgage recap that is provided by the mortgagee.

For prospects that rent, rather than own, their homes, that same option—to stay in one’s home—can usually be provided by establishing a rent fund equal to 120 times the current monthly rent.

Whether it may be appropriate to actually redeem the mortgage or just to make the mortgage payments as they come due will usually depend upon the economics of the transaction at the time of death. The important thing is to give the survivors the option of staying in their own home.

## Dependent Care

Determining the cost to provide dependent care—our next category of lump-sum cash needs—is somewhat more difficult than calculating the funds needed to liquidate a mortgage. To begin with, we need to understand that the term “dependents” may be broader than simply children. In the sense in which we are using the word, “dependents” may mean minor children or anyone else who is dependent upon the prospect.

For example, if the prospect routinely maintains his aged parents’ home, they would be dependent upon him or her for that service. Or, if the prospect provides a home for a handicapped brother or sister, that sibling might be unable to provide for himself or herself upon the prospect’s death and would, certainly, be considered a dependent. The dependent care fund is designed to pay for the additional dependent care expenses—for adults or children—that result from the death of a prospect formerly handling these duties without payment.

The approximate requirement for a dependent care fund is the current cost to obtain those services times the number of years until the child or adult can be expected to no longer require such care. In the case of a 10 year-old child, the calculation may be simple. In the case of an aged parent or handicapped child, the calculation may be much more difficult.

## Education

The last category on our list of lump-sum cash needs was education. For many prospects, however, the education of their children is pretty close to the top of any list of needs. In this category, you should include funds to ensure that any children have the opportunity to receive a suitable education. In addition, however, many prospects will want to provide the funds to allow a surviving spouse to return to school.

Although the amount of funds required will vary significantly depending upon the school chosen, whether or not the student will live at the school, any available scholarships and other aid, the minimum amount that many insurance planners suggest is $20,000 to $25,000 per year for each student.

## Summary

In this lesson, we focused on the lump-sum needs of surviving family members upon the death of the breadwinner. We noted that those needs generally include immediate cash to pay medical and burial expenses, taxes and estate administration expenses, funds to liquidate consumer and mortgage debt, and cash to establish an emergency fund, provide dependent care and ensure survivors’ education.

## Test Your Comprehension

1. Which of the following is NOT considered an immediate cash need at the death of a breadwinner?

1. education costs
2. burial expenses
3. federal estate taxes
4. unreimbursed hospital costs

2. What is the guideline amount normally allocated in personal life insurance planning for a survivor’s emergency fund?

* 1. $10,000
  2. 1 month’s income
  3. 6 month’s income
  4. $15,000

# Chapter 4 Social Security Survivor Benefits

## Important Lesson Points

* The most important survivor need following the death of a breadwinner is usually the need to replace the deceased breadwinner’s income.
* A major source of income replacement for many survivors is Social Security.
* A worker may be currently insured or fully insured for Social Security benefits.
* Fully insured survivor benefits are more comprehensive than currently insured survivor benefits.
* A Mother’s or Father’s Social Security benefit is generally provided to the unmarried surviving spouse of a covered worker who is caring for a deceased worker’s child younger than 16.
* Social Security benefits may be reduced or lost entirely if a Social Security recipient younger than 65 has earned income in excess of certain modest earnings limits.
* A child’s Social Security benefit is generally payable to an unmarried child of a deceased worker under age 18.
* A widow’s or widower’s blackout period may occur—during which no Social Security benefits are payable—when a deceased worker’s children reach age 18 and before the surviving spouse reaches age 60.
* A Widow’s or Widower’s Social Security benefit may begin for a qualifying surviving spouse at age 60.

## Chapter Learning Objectives

In this chapter we will look at Social Security survivor benefits and their importance in the personal life insurance planning process.

When you have completed this chapter you should be able to:

* Determine the difference between “currently insured” and “fully insured” and the consequences for surviving family members of the worker’s Social Security insured status;
* Calculate the Social Security survivor benefits lost by a beneficiary’s receipt of excess earned income; and
* List the criteria applicable to eligibility for each Social Security survivor benefit.

## Introduction to Social Security Benefits

There are other needs that surviving families have, of course. The most important of those needs is for income to replace the income provided by the deceased breadwinner. Before reviewing those needs, however, let’s turn our attention to the benefits—predominantly income benefits—that are provided by Social Security.

### Important Social Security Definitions

In order to better understand the significant benefits provided by Social Security, we need to get some definitions used in the Social Security system out of the way.

The definitions that we need to clearly understand are those for:

* Primary Insurance Amount
* Currently Insured
* Fully Insured
* Quarter of Coverage

The Primary Insurance Amount is the basic unit used to determine the amount of each monthly benefit payable under Social Security. The Primary Insurance Amount is based on the worker’s earnings and is the benefit that a worker would receive at the normal retirement age.

Since the definitions of fully insured and currently insured—definitions that are important for determining available coverage—involve the concept of quarter of coverage, let’s explain that next.

A worker accrues one quarter of coverage when he or she earns a particular amount of income. The amount of income needed to accrue a quarter of coverage increases each year. For 2015, a worker accrues a quarter of coverage for each $1,220 of earnings, up to a maximum of four quarters in each calendar year. Therefore, a worker earning $4,880 or more in 2015 will accrue four quarters of coverage. **Note: a worker cannot accrue more than four quarters of coverage in any calendar year.**

The quarters of coverage are not used to determine the size of an individual’s benefit. They are used only to determine his or her insured status. That is, whether the individual is fully insured or currently insured.

To be fully insured for Social Security benefits, an individual generally must have accrued 40 quarters of coverage. Once an individual has accrued 40 quarters of coverage, he or she is fully insured for life—even if he or she spends no further time in covered employment.

To be currently insured for Social Security benefits, an individual must have at least 6 quarters of coverage during the 13-quarter period ending with the calendar quarter in which he or she died. As we might expect, the benefits to which a fully insured worker is entitled are greater than the benefits to which a currently insured worker is entitled.

Let’s turn our attention to those benefits now.

## Currently Insured Social Security Survivor Benefits

We talked about the cash needs that the surviving family has on the death of a breadwinner, without preceding that discussion by an examination of lump-sum Social Security benefits. The reason for that is simple: lump-sum Social Security death benefits are generally insignificant. Social Security provides only a token lump-sum benefit of $255 at the death of a worker who is either currently insured or fully insured.

Where Social Security benefits make a significant impact is in their providing of survivor income. Some of those survivor income benefits, however, depend upon whether the deceased worker was currently insured or fully insured. Let’s look at the survivor benefits available to the family of the currently insured worker.

The surviving families of currently insured workers are entitled only to the following income benefits:

* A Mother’s or Father’s benefit, which is a monthly benefit for a widow or widower who is caring for at least one child under the age of 16; and
* A Child’s benefit, which is a monthly benefit for each child who is under age 18 (under age 19 if attending elementary or high school).

**Note that the family of a currently insured worker is not entitled to a widow’s or widower’s Social Security Benefit.**

## Fully Insured Social Security Survivor Benefits

The surviving families of fully insured workers are entitled to these two survivor income benefits—a Mother’s or Father’s benefit and a Child’s benefit—and, in addition, to the Widow’s or Widower’s benefit. The Widow or Widower’s benefit can begin as early as age 60.

### Mother’s or Father’s Benefit

The Mother’s or Father’s benefit is a Social Security income benefit that is payable provided the surviving spouse meets four important criteria. Those criteria are:

1. The surviving spouse must be caring for the child of a deceased worker who is less than 16 years old.
2. The surviving spouse must not be married.
3. The surviving spouse is not entitled to a Widow’s or Widower’s benefit.
4. The surviving spouse is not entitled to a retirement benefit based on his or her own work record that is equal to or larger than the amount of the mother’s or father’s benefit.

The amount of the Mother’s or Father’s benefit is equal to 75% of the deceased spouse’s primary insurance amount—also called the PIA. (See inset below) The Mother’s or Father’s benefit may be reduced, however, if the total benefit payable to the surviving family would exceed the Maximum Family Benefit.

|  |
| --- |
| Primary Insurance Amount (PIA) |
| The Primary Insurance Amount is the basic unit used to determine the amount of each monthly benefit payable under Social Security. The PIA is determined according to a wage-indexing formula, which expresses a worker’s prior years’ earnings in terms of their current dollar value. |

Even if the total benefit payable to the surviving family would NOT exceed the Maximum Family Benefit, there is another way that benefits may be reduced. If a beneficiary under the age at which he or she is eligible for full Social Security retirement benefits has earned income in excess of specific amounts, some or all of the Social Security benefits may be lost. Social Security rules refer to these earnings as “excess earnings.”

It is important to realize that it is only *earned income* that will cause a loss of Social Security benefits. Receiving unearned income—dividends, capital gains and interest—does not result in a loss of Social Security benefits. The system penalizes many Social Security beneficiaries that must work by reducing their benefits.

Under a law that became effective on January 1, 2000, the earned income of a fully retired worker—that means a Social Security recipient who has reached the age at which he or she is eligible for full Social Security retirement benefits or older—does not affect his or her Social Security benefits. However, a Social Security recipient younger than the age of eligibility for full retirement benefits will lose $1 of benefits for each $2 that he or she earns in excess of the earnings limits. The full retirement age depends on the recipient’s year of birth and is shown in the chart below:

|  |  |
| --- | --- |
| **Year of Birth** | **Full Retirement Age for Social Security Benefits** |
| 1937 or earlier | 65 years |
| 1938 | 65 years, 2 months |
| 1939 | 65 years, 4 months |
| 1940 | 65 years, 6 months |
| 1941 | 65 years, 8 months |
| 1942 | 65 years 10 months |
| 1943 – 1954 | 66 years |
| 1955 | 66 years, 2 months |
| 1956 | 66 years, 4 months |
| 1957 | 66 years, 6 months |
| 1958 | 66 years, 8 months |
| 1959 | 66 years, 10 months |
| 1960 or later | 67 years |

The earnings limit can be expected to increase each calendar year, so a Social Security benefit recipient younger than the full retirement age will be able to earn more in each subsequent year without a reduction in Social Security benefits. For 2015, the earnings limit is $15,720. (See inset below for the effects of excess earnings on Social Security benefits.)

Consider the plight of a working widow with young children. Although she may be eligible to receive Social Security benefits, she could expect to lose $1 in benefits for every $2 of earned income in excess of the $15,720 limit—until all of her Social Security benefits are lost. After the loss of benefits, payment of taxes, commuting, day care and other expenses, it may not be an economically-sound decision to seek employment in her case.

So, based on the requirements to receive the benefit, the mother’s benefit and the father’s benefit ceases if the beneficiary remarries or the youngest child reaches age 16. In addition, the benefit can be reduced or eliminated because of the beneficiary’s excess earnings.

For example, suppose Barbara, a Social Security recipient younger than the normal retirement age, is eligible to receive $10,000 annually in Social Security benefits. If the Social Security earnings exempt amount is $15,720 and Barbara has earnings from employment of $21,720 for the year, she will have excess earned income of $6,000. ($21,720 - $15,720 = $6,000) Each two dollars of excess earnings reduces her Social Security benefit by $1. So, all we need to do to determine the amount of Social Security benefits lost due to excess earnings is to divide the excess earnings by 2. Doing so, we can see that Barbara will lose $3,000 in Social Security benefits. ($6,000 ÷ 2 = $3,000) Thus, her $10,000 annual Social Security benefit will be reduced to $7,000. ($10,000 - $3,000 = $7,000)

|  |  |  |
| --- | --- | --- |
| Effect of Excess Earnings on Social Security Benefits | | |
| For Social Security Benefit Recipients Younger than Full Retirement Age (2015) | | |
| If Recipient’s Monthly Social Security Benefit is | And Recipient Earns | Recipient’s Yearly Benefit Will Be |
| $500  $500 | $15,720 or less  $17,240 | $6,000  $5,240 |
| $700  $700  $700 | $15,720 or less  $17,240  $21,240 | $8,400  $7,640  $5,640 |
| $900  $900  $900 | $15,720 or less  $17,240  $21,240 | $10,800  $10,040  $8,040 |

**Child’s Benefit**

In addition to the surviving spouse’s Social Security benefit, Social Security also pays a benefit to the child of a deceased worker. In order for the child to receive a benefit, the worker must have been either currently insured or fully insured.

For the child’s benefit to be payable, the child must be:

1. Under age 18 (or over age 18 and disabled) or under age 19 and a full-time elementary or secondary student;
2. Unmarried; and
3. Dependent upon the deceased parent.

Although this is less likely than for other Social Security beneficiaries, children may also have their benefits reduced because of excess earnings—according to the same calculation we examined in connection with the Mother’s or Father’s benefit.

**Widow’s & Widower’s Benefit**

One of the important periods in a widow’s or widower’s financial life is called the blackout period. This is a period of time during which no Social Security benefits are payable. The blackout period may end when the surviving spouse reaches age 60 and becomes eligible for the Widow’s & Widower’s benefit.

For benefits to be payable to a surviving spouse under the Widow’s & Widower’s benefit, there are several criteria that must be met. Those criteria are:

1. The deceased worker must have been *fully insured*; a widow or widower’s benefit is not payable if the deceased worker had been only currently insured.
2. The surviving spouse must be at least age 60 (or age 50 and disabled).
3. The surviving spouse must not be re-married prior to age 60 unless the subsequent marriage ends.

**Blackout Period**

We have alluded to the Social Security blackout period several times in this course—and will refer to it several times more before we’re finished. So, let’s define what we mean when we talk about the “blackout period.”

The blackout period is simply that period during which the surviving spouse is entitled to no Social Security benefits. That period normally begins for surviving spouses when there is no child of the deceased worker under age 18 who is entitled to a child’s benefit. The blackout period normally ends for surviving spouses when his or her widow’s or widower’s benefits begin at age 60. Not unexpectedly, this blackout period is one that often requires the largest part of the total capital needed to provide income to the surviving family members.

## Summary

This lesson examined the substantial survivor benefits provided by Social Security. The benefits discussed include the Mother’s and Father’s benefit, payable during the minority of the deceased’s children, the Child’s benefit, generally payable until the child becomes age 18, and the Widow’s and Widower’s benefit, normally payable beginning at age 60.

The time period following the termination of a Child’s benefit and the commencement of a Widow’s or Widower’s benefit is known as the blackout period. During this period, no survivors’ Social Security benefits are normally payable.

## Test Your Comprehension

1. For which of the following Social Security benefits are surviving families of currently insured workers ineligible?

* 1. widow’s or widower’s benefit
  2. lump-sum death benefits
  3. mother’s or father’s benefit
  4. child’s benefit

2. Which of the following is NOT a criterion that must be met by the surviving spouse of a deceased worker covered by Social Security for him or her to be eligible to receive a Social Security widow’s and widower’s benefit?

The deceased worker must have been fully insured

The non-disabled surviving spouse must be at least age 60

The surviving spouse must not be remarried before age 60 unless the subsequent marriage ends

The surviving spouse must not be receiving earned income from employment

3. Sharon is a surviving spouse of a deceased covered worker who is eligible to receive $1,000 monthly as a mother’s Social Security benefit. What amount of mother’s Social Security benefit will she receive in 2015 if she also received $12,000 of dividends, $18,000 of long-term capital gains, $6,000 of interest and $25,720 of earnings from her part-time clinical psychology practice in that year?

$0

$12,000

$7,000

$1,080

# Chapter 5 Identifying Income Needs At Death

## Important Lesson Points

* There are three easily identifiable periods in the life of the deceased worker’s survivors during which additional income is usually needed: the dependency, blackout and retirement periods.
* The dependency period is generally considered the most significant period of financial uncertainty for survivors — and one during which the income needed may be the highest.
* Despite the high need for additional family income during any of the periods in which Social Security benefits are paid, a surviving spouse’s earned income may reduce Social Security benefits and further worsen the income problem.
* The blackout period begins at the conclusion of the dependency period and continues until the surviving spouse’s age 60. During this period, no Social Security survivor benefits are usually payable.
* Although Social Security benefits may begin anew during the surviving spouse’s retirement period, income from employment normally ceases, thereby increasing the need for additional income.

## Chapter Learning Objectives

In this chapter we will look at surviving families’ income needs following the death of a breadwinner.

When you have completed this chapter you should be able to:

* Describe when a surviving family’s dependency period, blackout period and retirement period begin and end;
* Explain when the Social Security mother’s or father’s benefit ends; and
* Identify when the Social Security child’s benefit ends.

## Introduction

Although a family’s need for sufficient income is ongoing, there are three distinct periods during which a surviving family and/or spouse normally needs additional income to supplement the survivor benefits provided by Social Security. Those periods are the:

* Dependency period
* Blackout period
* Retirement period

## The Dependency Period

The dependency period is that period of time that:

* Begins at the death of the breadwinner with minor children; and
* Ends when the youngest child is age 18 (age 19 if the child is attending elementary or high school).

Because of minor children, the income needed during the dependency period is likely to be the highest. In addition, for many families, this is also the most significant period of financial uncertainty.

It doesn’t require much imagination to be able to picture the widow or widower with several small children wondering where the money will come from to pay for all the things that are a part of growing child’s life—from braces to prom dresses. And, at the same time, hoping that nobody gets sick because the lowest deductible on the health insurance they can afford is $500 or $1,000.

Fortunately, this is the period of maximum Social Security benefits for the surviving family. However, if the income provided for the family through Social Security and invested capital is not sufficient to raise the family, the surviving spouse may be required to enter the job market. Unfortunately, if that occurs, those current Social Security benefits may be seriously reduced.

The possible reduction of a surviving family’s Social Security benefits is one of the unfortunate paradoxes of Social Security. If a surviving family is unable to live on Social Security benefits along with their assets or the income from those assets, a widow may have to take a job just to earn enough to pay bills. Unfortunately, this earned income may result in a reduction of the Social Security benefits that were insufficient in the first place.

As we noted earlier, in our discussion of Social Security, only *earned income* can reduce Social Security benefits. Unearned income has no effect on the level of Social Security benefits. Overall, the greatest source of unearned income to survivors of covered workers is life insurance.

We saw, in our discussion of Social Security benefits, that dependency period income is comprised of two separate payments:

* Surviving spouse’s income
* Children’s income

Although the actual payment received may be in a single monthly check, the benefit is typically made up of a surviving spouse’s benefit and a children’s benefit. Not only are these separate benefits, but they may also cease at different times. Social Security survivor benefits during the dependency period cease for the surviving spouse and the children as shown below:

* For the surviving spouse (mother’s or father’s benefit) when his or her youngest child reaches age 16
* For children (child’s benefit) when the child reaches age 18 (19 if in elementary or high school)

When both of these dependency benefits terminate, the Social Security blackout period begins.

## The Blackout Period

The blackout period can be an especially cruel time for families of a deceased breadwinner. For surviving families, the financial lights go out during the blackout period. All Social Security benefits normally cease. In many cases, just when these benefits stop, the need for money increases as college expenses begin.

The blackout period continues until Social Security benefits re-commence at the surviving spouse’s retirement age. Although the surviving spouse’s full benefits may begin at his or her full retirement age, reduced benefits may begin as early as age 60.

## The Survivor’s Retirement Period

Although Social Security benefits begin again during the surviving spouse’s retirement period—called *retirement*, rather than *survivor*, benefits—other income may have ceased. The income from employment that the surviving spouse may have received during the blackout period usually stops upon retirement.

The employer-provided pension benefits that workers may have been able to rely upon at retirement in years past have dried up for many workers. Instead, these pensions have been replaced—in many cases—by 401(k) plans to which the surviving spouse has been required to make contributions in order to receive any benefit. In other cases, they have not been replaced by any retirement plan at all.

Often the surviving spouse’s retirement income is not sufficient and must be augmented with other funds during the survivor’s retirement period. However, earned income may reduce these Social Security retirement benefits just as they reduced the Social Security dependency period benefits, if the surviving spouse is younger than the full retirement age.

## Summary

This chapter focused on the identification of the survivors’ income needs following the death of a breadwinner. Although the need for income is ongoing in all families, three periods in the financial life of survivors were identified. Those identified periods are the dependency, blackout and retirement periods.

Despite the additional income needs often experienced by families of deceased breadwinners, needed Social Security benefits may be reduced if the surviving spouse has earned income in excess of permitted limits. Although these Social Security benefits may be reduced as a result of the survivors’ earned income, they are not affected by the beneficiaries’ receipt of unearned income or life insurance benefits. This fact alone emphasizes the need for adequate life insurance coverage.

## Test Your Comprehension

1. Edna is the 54 year-old widow of a worker covered under Social Security and is receiving a Social Security mother’s benefit. In 2015, her three children are ages 12, 14 and 15. When will her mother’s or father’s benefit end?

In one year

In three years

In four years

In six years

2. Audrey is the 46 year-old widow of a worker covered under Social Security and is receiving a Social Security mother’s benefit. Her three children are currently ages 12, 14 and 15. What is the shortest period during which she will experience the Social Security blackout period?

1. Eight years
2. Thirteen years
3. Eleven years
4. Ten years

3. Cindy, the surviving spouse of a worker who was fully insured for Social Security, began taking Social Security retirement benefits at her full retirement age last year. Even though she will receive interest earnings of $20,000 and dividends of $6,080 in 2015, she is continuing employment and expects to earn $25,240 in 2015. By what amount, if any, will her $22,000 Social Security retirement benefit be reduced?

1. $4,760
2. $0
3. $5,180
4. $17,800

# Chapter 6 Calculating Survivor Income Needs at Death

## Introduction

Now that we have generally examined some of the important financial issues faced by the surviving family following the death of a breadwinner, let’s turn our attention to calculating the amount of funds needed to provide an appropriate level of income during these three periods.

Before we begin our calculations, we need to think about the factors that can affect the amount of funds that are needed at death to produce income. Those factors are:

* Future inflation rates
* Future investment returns

Both future investment returns and future inflation rates dramatically affect the amount of funds that are needed to produce a particular income. The future inflation rate affects the amount of funds required to produce an income because inflation reduces purchasing power.

Not only is income necessary for the surviving family, its ability to maintain its purchasing power is also critical. What that means, of course, is that as inflation erodes the purchasing power of a dollar, more income dollars must become available, and that requires more invested funds.

## Chapter Learning Objectives

In this chapter we will look at the methods used to calculate the amount of assets required to provide for surviving families’ income needs following the death of a breadwinner.

When you have completed this chapter you should be able to:

* Calculate the amount of life insurance needed to provide survivor income liquidating capital and income; and
* Calculate the amount of life insurance needed to provide survivor income using income only and retaining capital.

## A Process of Estimation

The reliance on future inflation rates and unknown investment returns tells us that the calculation of survivor income needs is, at best, an estimate. Since both of the important variables—future inflation rates and future investment returns—are unknown, it is impossible to determine exactly the amount of funds that are needed to produce an income whose purchasing power remains stable over several years. Having said that, however, we still need to make the estimate.

Fortunately, there are certain steps that can be followed in calculating survivor income needs at death and in determining the amount of capital that the surviving family needs in order to produce a particular level of income. We will use that process in making our calculations.

The process of calculating the amount of assets needed to provide for the income needs of survivors at the death of a breadwinner follows certain steps. Those steps are indicated below:

1. Project survivor income needs based on current annual gross income.
2. Deduct anticipated income from existing income sources, such as, Social Security benefits, surviving spouse’s earnings, trust income, inheritances, etc.
3. Determine the present value of the future income needs over the period during which the income will be required. (Non-discounted dollars may be used to a) simplify the calculation and b) account for possible inflation erosion of survivor income.)
4. Determine whether the prospect wishes to retain capital (and use earnings only for income) or wants to liquidate capital as part of the income.
5. Total the capitalized value of the income needs for each of the three income periods: dependency period, blackout period and retirement period.
6. Subtract from the total capitalized value any currently-owned liquid assets available to provide income that were not needed to meet lump-sum cash needs—cash, securities, life insurance death benefit proceeds, etc.

The result of this calculation is an estimation of the amount of additional life insurance death benefits required to meet the prospect’s income needs for his or her surviving family.

## Determining the Capital Need

When determining the amount of life insurance needed to provide income, you should see the life insurance as being nothing more or less than invested cash. So, when you try to answer the question: “How much life insurance does my client need?” you are really asking how much invested cash the client needs in order to produce the desired amount of income.

For example, if the client needs to provide income of $5,000 every year beginning immediately, wants to avoid eroding capital, and expects to obtain a consistent 5% yield on invested capital, he or she need to invest $100,000. To determine the amount of capital in that case, you need only divide the needed annual income by the assumed rate of return. Thus $5,000 ÷ .05 = $100,000.

Thus, if the client needs to obtain a $5,000 annual income from an investment and the client can obtain a 5 percent return, he or she needs to have invested $100,000. Often, however, the answer isn’t quite that simple. Usually, there are two reasons for the greater complexity:

1. The income is not required until several years after the client dies; and
2. The client wants to use capital as well as interest to provide the needed income.

Sometimes, both complications are involved. Let’s take each of these issues separately.

### When Income is Not Needed for Several Years

In order to determine the amount of invested cash the client needs today that will grow to the required amount in the future, you must discount that amount to the present; in other words, you need to find its present value. A present value answers the question: “How much money must I have invested today to enable me to have a certain specified amount of money in the future. It sounds complicated, but it isn’t. Let’s consider an example.

Suppose the $5,000 annual income that your client wants to provide is not needed by his or her survivors until five years after the client’s death. To determine the amount of invested cash needed in five years to produce that income, assuming that the income earned during the initial five-year period is just accumulated, i.e., added to the invested cash, you need to look at the compound discount table reproduced in Appendix B.

If 5% interest is assumed and the $100,000 isn’t needed for five years, look in the table for where 5 years and 5% intersect; you will notice the factor shown—as indicated in the excerpt below—is .7835.

**Present Value Factor for a $1 Future Lump Sum**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 1  2  3  4  5 | .9804  .9612  .9423  .9238  .9057 | .9709  .9426  .9151  .8885  .8626 | .9615  .9246  .8890  .8548  .8219 | .9524  .9070  .8638  .8227  .7835 | .9434  .8900  .8396  .7921  .7473 | .9346  .8734  .8163  .7629  .7130 | .9259  .8573  .7938  .7350  .6806 |

By multiplying the amount of invested capital needed in five years—$100,000 in this case—by the factor of .7835, we can see that the client needs only $78,350 at the time of death to produce the needed amount of capital in five years. ($100,000 x .7835 = $78,350) In five years, that amount will grow to $100,000 if invested at 5%. At that time, the $100,000 of invested capital can begin producing $5,000 of annual income.

### The Client Wishes to Use Interest and Capital

Sometimes, in order to minimize the amount of life insurance needed to produce the desired income for survivors, a client will choose to use both income from invested assets and the invested assets themselves to provide the income. In other words, the client wants to *annuitize* the invested capital to provide income. To determine the amount of capital needed if it is to be annuitized, you should look at the compound discount table reproduced in Appendix A. To illustrate, we will return to our client who wants to provide $5,000 each year to survivors.

Before consulting the table, you should assume the first year’s income of $5,000 comes directly from invested assets rather than being part assets and part income. Hence, we will put that amount aside to add to the total assets needed to provide the income for years after the first.

Suppose your client wants to provide an annual income of $5,000 to survivors for 15 years. We need to determine how much he or she needs in current invested assets to provide $5,000 each year after the first year—for 14 years. (Remember, the first year’s income is provided by the $5,000 we earmarked for it.) So, look at the compound discount table in Appendix A and find where 14 years and 5% intersect. You can see the factor is 9.8986.

**Present Value Factor for a $1 Annuity**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 1  2  3  4  5  6  7  8  9  10  11  12  13  14  15 | 0.9804  1.9416  2.8839  3.8077  4.7135  5.6014  6.4720  7.3255  8.1622  8.9826  9.7868  10.5753  11.3484  12.1062  12.8493 | 0.9709  1.9135  2.8286  3.7171  4.5797  5.4172  6.2303  7.0197  7.7861  8.5302  9.2526  9.9540  10.6350  11.2961  11.9379 | 0.9615  1.8861  2.7751  3.6299  4.4518  5.2421  6.0021  6.7327  7.4353  8.1109  8.7605  9.3851  9.9856  10.5631  11.1184 | 0.9524  1.8594  2.7232  3.5460  4.3295  5.0757  5.7864  6.4632  7.1078  7.7217  8.3064  8.8633  9.3936  9.8986  10.3797 | 0.9434  1.8334  2.6730  3.4651  4.2124  4.9173  5.5824  6.2098  6.8017  7.3601  7.8869  8.3838  8.8527  9.2950  9.7122 | 0.9346  1.8080  2.6243  3.3872  4.1002  4.7665  5.3893  5.9713  6.5152  7.0236  7.4987  7.9427  8.3577  8.7455  9.1079 | 0.9259  1.7833  2.5771  3.3121  3.9927  4.6229  5.2064  5.7466  6.2469  6.7101  7.1390  7.5361  7.9038  8.2442  8.5595 |

So, by multiplying the needed $5,000 per year in income by the factor of 9.8986, we can see that the client needs to have $49,493 invested to provide *14 years* of income of $5,000 each year. To that amount of capital required to provide the 14-year income stream beginning in one year, of course, we need to add the $5,000 for the first year’s income to arrive at $54,493. ($49,493 + $5,000 = $54,493)

The present value factor simply gives you the easy answer to the following calculations:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Year** | **Total Withdrawn** | **Withdrawn from Principal** | **Withdrawn Interest** | **Remaining Principal** |
| 1 | $0 | $0 | $0 |  |
| 2 | 5,000 | 2,525.35 | 2,474.65 | 46,967.65 |
| 3 | 5,000 | 2,651.62 | 2,348.38 | 44,316.03 |
| 4 | 5,000 | 2,784.20 | 2,215.80 | 41,531.83 |
| 5 | 5,000 | 2,923.41 | 2,076.59 | 38,608.43 |
| 6 | 5,000 | 3,069.58 | 1,930.42 | 35,538.85 |
| 7 | 5,000 | 3,223.06 | 1,776.94 | 32,315.79 |
| 8 | 5,000 | 3,384.21 | 1,615.79 | 28,931.58 |
| 9 | 5,000 | 3,553.42 | 1,446.58 | 25,378.16 |
| 10 | 5,000 | 3,731.09 | 1,268.91 | 21,647.07 |
| 11 | 5,000 | 3,917.65 | 1,082.35 | 17,729.42 |
| 12 | 5,000 | 4,113.53 | 886.47 | 13,615.89 |
| 13 | 5,000 | 4,319.21 | 680.79 | 9,296.68 |
| 14 | 5,000 | 4,535.17 | 464.83 | 4,761.52 |
| 15 | 5,000 | 4,761.92 | 238.08 | 0 |

We can see from the table above that providing 14 years of an annual income of $5,000 beginning at the end of the first year would require the individual to withdraw $2,525.35 from capital to supplement the $2,474.65 in the first year and increasing amounts in subsequent years. At the end of the period, the capital would have been reduced to zero.

### Using Interest and Capital- Income Not Needed for Several Years

In many cases, both of the preceding conditions—liquidation of assets and a delayed start in required income—apply. Accordingly, often you will encounter the need to calculate the amount of assets that must be invested for a client who wants to use both interest and capital to provide income *and* the income won’t be needed by survivors for several years. In other words, what amount of capital is required if the income needed doesn’t have to begin until some date in the future? In that case, two calculations are required: (1) a calculation to determine how much capital is needed when the income is scheduled to begin, and then (2) a calculation to determine how much capital is needed now in order to have the needed capital at the time the income is scheduled to begin. Arriving at the appropriate amount is relatively simple.

In the last section we calculated the amount of assets needed for a client that wants to provide $5,000 of annual income, will use both interest and capital, and expects to earn 5% each year. The amount was $54,493. That is the amount of capital the client needs at the time his or her income from the capital is scheduled to begin. But, what if the income isn’t needed until five years have passed? The $54,493 will be needed **then**, but a smaller invested amount will be needed **now** in order to produce the $54,493. That smaller amount will grow at interest into the amount needed at the time income is needed.

Thus, if income isn’t needed for five years in the future, all we need to do is go back to the compound discount table found in Appendix B—the one we used in our first example—and determine the present value of the $54,493 capital needed to provide the income that will begin in five years.

Assuming that the client can expect to earn 5 percent annually on the funds, we need to look in the table for where 5 years and 5% intersect; the factor—as we found before—is .7835.

**Present Value Factor for a $1 Future Lump Sum**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 1  2  3  4  5 | .9804  .9612  .9423  .9238  .9057 | .9709  .9426  .9151  .8885  .8626 | .9615  .9246  .8890  .8548  .8219 | .9524  .9070  .8638  .8227  .7835 | .9434  .8900  .8396  .7921  .7473 | .9346  .8734  .8163  .7629  .7130 | .9259  .8573  .7938  .7350  .6806 |

If we just multiply the $54,493 of invested assets (needed at the time income must begin) by the .7835 factor, we can see that the client must invest $42,695 today to have $54,493 in five years. ($54,493 x .7835 = $42,695) At that time, the $54,493 will be used to provide the needed income using both interest and capital.

## Projecting Future Income Needs

In order to project a family’s future income needs, the place that we need to begin is with the family’s current gross annual income. Presumably, that is what the prospect and his or her family are currently living on. You may remember, in our discussion of human life values, that we talked about the portion of an individual’s income that is used to maintain the family.

The percentage of the family’s current income that actually was used to maintain the family was generally a function of the family’s income level. We noted that a general rule of thumb tells us that about 2/3rds of lower-income earners’ income is devoted to maintaining a family while 1/2 or less of high-income earners’ income goes towards family maintenance.

In data gathering with the prospect, it is the prospect and his or her family that should be determining the level of income that will be provided. However, the agent may have to guide him or her to arrive at reasonable income objectives. That is the best use of this required-income rule of thumb.

Suggested survivor income percentages based on your prospects’ current income may be used to guide your prospects to determine reasonable survivor income levels. The survivor income level that the prospect decides on, however, is the level that you should use.

Breadwinners often want their survivors to be able to continue to live after their death in much the same way they did before it. That desire must be translated into income for the survivors. To determine the income that will enable the surviving family to continue to enjoy their current lifestyle, you should reduce the family’s current income by the cost to maintain the deceased breadwinner. The table below offers guidelines that may be applicable to many families.

|  |  |
| --- | --- |
| Family’s Current Annual Gross Income | Guideline Percentage of Income Required To Maintain Current Lifestyle |
| Up to $65,000 | 70% |
| $65,000 — $75,000 | 65% |
| $75,001 — $90,000 | 60% |
| More than $90,000 | 50% |

Let’s assume that Dan Johnson, our $70,000 per-year prospect, has decided that our guidelines are appropriate for his family and wants to provide survivor income that is equal to 65% of his current income. That means, of course, that if he died tonight, he would want his family to receive $45,500 each year.

Dan’s spouse, Susan, is age 30, and they have a son, Billy, age 8. For purposes of this example, we will assume that the only existing income source is Social Security and that they have neither liquid assets nor existing life insurance. Social Security will pay a monthly income of $2,500 until Billy is age 16. At that time, Susan’s benefit will cease, and Billy’s benefit of $1,250 will be payable for another two years. When Susan reaches age 60, her benefit will resume at $1,200 per month.

## Dependency Period

We know the amount of annual income that Susan and her son, Billy, need; that amount is $45,500. We also know the annual income that Social Security will provide until Billy is age 16; that amount is $30,000. Since we know those two important values, our job is a relatively simple one: to determine how much money would be need immediately to provide an income stream of $15,500 for the 8 years until Billy reaches age 16—the difference between the $45,500 that is needed and the $30,000 that will be provided. This is the first part of the dependency period.

By using a compound discount table to determine the present value of $1 annuity (See Appendix A or the excerpt below), we can determine the present value of that $15,500 payable for the next 8 years based on the investment return rate that the prospect chooses. Although the agent should use the percentage rate that the prospect indicates, a rate of 5 percent is generally considered appropriate. An easy way to conceptualize the 8-year dependency period is to see it as being made up of the current year and the following 7 years.

Go to the 5% column and come down to 7 years. You will note that the factor for the present value of a 7-year income stream at 5% is 5.7864. By multiplying the $15,500 that we need to provide for that 7-year period beginning in 1 year by the factor of 5.7864, we will find the amount of capital needed for that period. The answer, of course, is $89,689. ($15,500 x 5.7864 = $89,689)

**Compound Discount Table (excerpt)**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Annuity | | | | | | | |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 4  5  6  7 | 3.8077  4.7135  5.6014  6.4720 | 3.7171  4.5797  5.4172  6.2303 | 3.6299  4.4518  5.2421  6.0021 | 3.5460  4.3295  5.0757  5.7864 | 3.4651  4.2124  4.9173  5.5824 | 3.3872  4.1002  4.7665  5.3893 | 3.3121  3.9927  4.6229  5.2064 |

However, our $89,689 answer is NOT the amount of capital that we need to have in order to provide the 8 years of income to Susan and Billy. It is only a part of the answer; it is the amount of capital, invested at 5 percent that will exactly produce their $15,500 annual income beginning at the end of the first year after Dan’s death. Susan and Billy need to have an income beginning immediately.

As we noted, the $89,689 of capital will provide 7 years of income of $15,500 beginning one year from now. Since Susan and Billy will need income for the year immediately following Dan’s death, we need to add an additional $15,500 to that. That brings the total capital that is needed to provide the 8 years of income to Susan and Billy to $105,189. ($15,500 + $89,689 = $105,189)

We have calculated the amount of income that Susan and Billy will need until Billy becomes age 16 to be $105,189. As we noted earlier, Susan’s Social Security benefit as a surviving spouse ceases when her youngest child reaches age 16, causing the monthly Social Security benefit to reduce to $1,250 each month until Billy reaches age 18 (age 19 if he is still in elementary or high school). Let’s assume that Billy has completed high school by the time he is age 18.

Since the Social Security benefit for those 2 years decreases from $30,000 to $15,000, we need to make up the difference of $30,500. (Remember, the family needs a total annual income of $45,500.) To calculate the amount of capital the surviving family needs now in order to provide that $30,500 for 2 years, beginning 8 years from now, we need to perform two calculations:

First, we need to determine how much money will be needed at the beginning of the 2-year period that will begin 8 years from now;

Then we need to determine the amount of money needed now to produce the required amount of income-producing capital at the end of 8 years.

To determine that amount, we need to make two present value calculations similar to the calculation that we have already made.

First we must determine how much money we need in 8 years to provide two years of $30,500 annual income. Then, we need to calculate the amount of money we need right now to come up with that amount.

To make the first calculation, return to the compound discount table for $1 annuity in Appendix A (excerpt shown below) and use the factor (5% for 2 years) of 1.8594. If we multiply the additional annual income ($30,500) that Susan and Billy need for that 2-year period by 1.8594, that will give us the amount of capital that we need at the beginning of that period in 8 years to provide it. By multiplying the then-needed annual income of $30,500 by the present value factor, we can see that we will need capital of $56,711 in 8 years to provide those two years of income. (1.8594 X $30,500 = $56,711)

**Compound Discount Table (excerpt)**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Annuity | | | | | | | |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 1  2 | 0.9804  1.9416 | 0.9709  1.9135 | 0.9615  1.8861 | 0.9524  1.8594 | 0.9434  1.8334 | 0.9346  1.8080 | 0.9259  1.7833 |

However, we still need to calculate how much money we need *today* to produce that $56,711 in required capital eight years from today. To do that, we need to find its present value by using a somewhat different present value chart that gives us the present value of a *future lump sum*, rather than a future income stream. (See Appendix B for the compound discount table for $1 lump sum.)

So, we can determine the amount of invested capital that we need today by finding the present value of the capital we need in 8 years. To do that we should go to our present value table for lump sums and read down the 5% column to 8 years. The present value factor that we need to use is .6768. (See table excerpt below.)

**Compound Discount Table (excerpt)**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Future Lump Sum | | | | | | | |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 7  8  9  10 | .8706  .8535  .8368  .8203 | .8131  .7894  .7664  .7441 | .7599  .7307  .7026  .6756 | .7107  .6768  .6446  .6139 | .6651  .6274  .5919  .5584 | .6227  .5820  .5439  .5083 | .5835  .5403  .5002  .4632 |

We should multiply the amount of capital that we need in 8 years—that was $56,711—by the factor of .6768. That will tell us how much capital we need right now to provide that two years’ income between Billy’s age 16 and his 18th birthday. That amount, of course is $38,382. ($56,711 X .6768 = $38,382)

By using these two present value calculations, we have determined the amount of capital that Dan and Susan would need to provide the income while Susan receives a Social Security benefit; that amount is $105,189. We have also determined the amount of capital needed to provide the additional income needed for the two year balance of the dependency period when Billy’s benefit continues; that amount is $38,382.

So, the total capital that Susan and Billy would need to exactly fund their dependency period is the total of $143,571. ($105,189 + $38,382 = $143,571) That is a substantial amount of capital, but not nearly the amount that will be needed during the next period, when all Social Security benefits cease—the blackout period.

## Blackout Period

Our next calculation is the one that usually produces the largest capital need—the capital needed for the blackout period. As we noted earlier, the blackout period is the time in the surviving widow or widower’s life after the dependency period and before he or she is eligible to receive Social Security retirement benefits. If the surviving widow or widower has no dependent children under age 18, the blackout period begins immediately upon the spouse’s death.

In our example, since Social Security has played such a dominant role in providing the survivor income for Susan and Billy during the dependency period, its loss during the blackout period would probably be felt keenly. In Susan and Billy’s case, Social Security income will have dropped from $30,000 a year for 8 years to $15,000 a year for 2 years and then finally to zero. Remember, 10 years have gone by since Dan died. Susan is now 40 years old.

Because Social Security income does not resume for Susan until she is age 60, at the earliest, the $45,500 of annual income that she and Dan wanted to provide upon his death will have to be made up from earned income and investment income. Since Susan may have been out of the job market for several years at the time of her husband’s death, many prospects want to provide that income required during the blackout period solely from investments. That often requires considerable capital.

Let’s determine how much capital Susan will need at the beginning of the 20-year blackout period if all of her income will be derived from investments. Remember the process that we need to use to determine the amount of capital we need right now to provide the blackout period income—years in the future. That process required two steps:

1. Determine the amount of capital needed at the beginning of the blackout period and then
2. Calculate the present value of that capital.

We need to make two calculations. The first calculation will tell us how much capital is needed at the beginning of the blackout period. The second calculation will tell us the amount of capital we need now to produce that amount of money.

To determine the amount of capital required at the beginning of the blackout period, we need to calculate the present value of the $45,500 yearly for 20 years. Using our 5% assumption and applying it to the compound discount table for $1 annuity in Appendix A, it should be clear that the factor that we need to use to determine the present value of the 20 years of income is 12.4622. (See table excerpt below.)

**Compound Discount Table (excerpt)**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Annuity | | | | | | | |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 18  19  20  25 | 14.9920  15.6785  16.3514  19.5235 | 13.7535  14.3238  14.8775  17.4131 | 12.6593  13.1339  13.5903  15.6221 | 11.6896  12.0853  12.4622  14.0939 | 10.8276  11.1581  11.4699  12.7834 | 10.0591  10.3356  10.5940  11.6536 | 9.3719  9.6036  9.8181  10.6748 |

Now that we know the present value factor to use, we just need to multiply the needed annual income—$45,500—by the factor. This will tell us how much capital we need at the beginning of that 20-year period to produce the income. We can see that the amount of money needed to produce that $45,500 each year at 5% is $567,030. ($45,500 x 12.4622 = $567,030)

That is not the amount of capital that is needed right now, however. Since the survivors in our example don’t need the $567,030 for another 10 years, they only require a smaller amount that can be invested to produce the $567,030 when needed. The $567,030 is the amount of capital that is needed at the beginning of the blackout period. That is 10 years from now. So, what we need to do is to calculate the amount that we need today to produce it; that is its present value.

The present value is just another way of determining the amount of capital that, along with interest, will produce $567,030 in 10 years. However, instead of using the present value of $1 annuity in Appendix A, we need to use the present value of a future lump sum shown in the compound discount table in Appendix B (excerpt shown below). The present value factor that we should use—assuming a 5% compound discount—to determine the capital we need today to produce the lump-sum needed in 10 years is .6139, shown highlighted below.

**Compound Discount Table (excerpt)**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Future Lump Sum | | | | | | | |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 7  8  9  10 | .8706  .8535  .8368  .8203 | .8131  .7894  .7664  .7441 | .7599  .7307  .7026  .6756 | .7107  .6768  .6446  .6139 | .6651  .6274  .5919  .5584 | .6227  .5820  .5439  .5083 | .5835  .5403  .5002  .4632 |

Since the present value factor that we are using is .6139, we are really saying that in order to produce one dollar in 10 years, we need to invest about 61 cents at 5% compound interest. So, if we want to produce $567,030 at the end of 10 years, we need to invest $348,100 at 5% at the beginning of that 10-year period. ($567,030 x .6139 = $348,100)

So, in order to be able to have $567,030 in 10 years, when the blackout period begins, we would have to invest $348,100 today at 5%. We can see that if the interest rate that we assumed was higher than 5%, the amount of capital needed would be reduced. The reason for that is simple. The higher the return that we can obtain on our capital, the less capital we would need to produce the desired result. Since more of the needed money would be interest, less is needed in invested principal. We know, however, that using a 5% interest assumption, Susan needs $348,100 of invested capital today to produce her blackout-period income. So far, we have calculated the capital needed to provide both the dependency period income ($143,571) and the blackout period income ($348,100).

## Retirement Period

Let’s go on to our last income period, Susan’s retirement income. Traditionally, this period has been considered to be 20 years. Since people are living longer, a prospect may want to lengthen that period to 25 or 30 years. For our purposes, however, we will assume that Susan begins her Social Security retirement income at age 60 and lives only until age 80. Therefore, we need to provide a supplementary retirement income for 20 years.

Earlier, we said that Susan could expect to receive a monthly Social Security retirement income of $1,200. In order for Susan to continue to have a total annual income of $45,500, she needs to supplement that $14,400 of annual Social Security benefits with an additional income of $31,100 each year for 20 years.

Our first step in calculating the amount of capital that Susan needs to provide that retirement income is to determine the present value of the twenty years of income from her age 60 to age 80. That will be the amount of capital that Susan will need at the beginning of her 20-year retirement period, which means that we, again, need to find a suitable present value factor. Staying with a 5% interest assumption, the factor that we need to use to give us the present value of that income stream (Appendix A and the excerpt below) is 12.4622.

**Compound Discount Table (excerpt)**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Annuity | | | | | | | |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 18  19  20  25 | 14.9920  15.6785  16.3514  19.5235 | 13.7535  14.3238  14.8775  17.4131 | 12.6593  13.1339  13.5903  15.6221 | 11.6896  12.0853  12.4622  14.0939 | 10.8276  11.1581  11.4699  12.7834 | 10.0591  10.3356  10.5940  11.6536 | 9.3719  9.6036  9.8181  10.6748 |

It is the same present value factor that we used for determining the blackout period capital requirement—since both periods, in this case, are 20 years in duration. So, at the beginning of Susan’s retirement period, she needs $387,574 of invested capital to produce a supplemental annual income of $31,100 for 20 years. ($31,100 x 12.4622 = $387,574)

However, since Susan is now 30 years old, she doesn’t need this capital to begin supplementing her retirement income for another 30 years when she will be 60 years old. That means that she doesn’t need all of that $387,574 today; instead, she needs a smaller amount of capital that she can invest today at 5% compound interest for 30 years. The amount of capital that is needed today is only $89,685.

All we need to do is to go to our compound discount table for a lump sum (Appendix B, excerpted below), and we can see that to produce a dollar in 30 years we need about 23 cents invested at 5%. The actual factor is .2314, the value highlighted in the table. If we multiply the $387,574 by .2314, that tells us that we need $89,685 now to produce $387,574 in 30 years if we invest it at 5% compound interest. The balance of the $387,574 is made up by interest on Susan’s invested capital of $89,685.

**Compound Discount Table (excerpt)**

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Future Lump Sum | | | | | | | |
| **Years** | **2%** | **3%** | **4%** | **5%** | **6%** | **7%** | **8%** |
| 20  25  30  40 | .6730  .6095  .5521  .4529 | .5537  .4776  .4120  .3066 | .4546  .3751  .3038  .2083 | .3769  .2953  .2314  .1420 | .3118  .2330  .1741  .0972 | .2584  .1842  .1314  .0668 | .2145  .1460  .0994  .0460 |

What we have done in our three calculations is to determine the amount of capital that Susan would need immediately upon Dan’s death—assuming that he died tonight—to provide income during each of the 3 periods. All that we need to do now is to add them up, and that will tell us how much capital Susan needs in order to provide income during the remainder of her life.

If we add up each of the components of the income need, we can see that it comes to $581,356. If Dan has no life insurance or other liquid assets that can be used to provide this income, he would need $581,356 of life insurance in addition to any life insurance that is needed to provide for Susan and Billy’s cash needs upon his death.

|  |  |
| --- | --- |
| Dependency period | $143,571 |
| Blackout period | 348,100 |
| Retirement period | + 89,685 |
| Total | $581,356 |

Calculating the capital needed at Dan’s death in the way we have just done it results in the least amount of capital needed—which really means, in most cases, the least amount of life insurance needed—to provide the income that his family needs upon his death. It provides for the use of both income from invested capital and the capital itself. In fact, it is the orderly liquidation of capital. Because this approach *liquidates* capital, it has 3 drawbacks.

The first drawback of liquidating capital to provide income is that, upon the surviving spouse’s death, all of the capital has been used to provide income; there is nothing left to pass on to children. The entire $581,356 has been liquidated. The second drawback is that, if the spouse lives beyond life expectancy, there may be no remaining capital to provide income. The third drawback is that, since the survivors must use capital in addition to the earnings on the capital to produce income, it is more difficult for them to adjust their income to make up for the buying power erosion resulting from inflation. These drawbacks can be overcome by using a somewhat different approach that retains capital instead of liquidating it.

## Capital Retention

The fundamental concept in capital retention is that sufficient capital must be provided so that the required income can be produced *solely* through investment earnings—rather than through investment earnings combined with liquidated principal.

Using the capital retention approach, we can calculate the capital needed to provide the income required by Susan and Billy. Since the capital retention approach uses only earnings to provide income, we can expect that it will require more capital than in our previous illustration. In fact, the capital required—assuming that only 5% return is assumed—is $630,579. What is startling in this number is that all the benefits of capital retention require only $49,223 more capital than the liquidation approach. By providing approximately $50,000 more life insurance, Dan and Susan can not only provide for Susan and Billy’s income and permit that income to avoid inflation-caused erosion of its purchasing power but also leave Billy with a sizable inheritance upon Susan’s eventual death. Let’s look at how to determine the life insurance need using a capital retention approach.

To more easily calculate the required life insurance using a capital retention approach, you should view the client’s income requirements in “layers.” (See inset below.) As you can see, there are four layers of income required based on our earlier example:

1. The income required from Dan’s death until Susan’s assumed death at age 80 that is represented by the line AE;
2. The income required from the date when Billy reaches age 16 (when Susan’s Social Security benefit ceases) until Susan’s assumed death at age 80 that is represented by the line BE:
3. The income required from the date Billy reaches age 18 (at which time him Social Security benefit ceases) until Susan’s assumed death at age 80 that is represented by the line CE; and
4. The income required from the date Billy reaches age 18 until Susan begins to again receive Social Security benefits at her age 60.

The total annual income provided for Susan and Billy, throughout the period needs to be $45,500 under the capital retention approach, just as it was in our earlier calculations.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Capital Retention Approach | | | | | |
| Providing survivor income through the capital retention approach can be more easily understood if we consider each income amount provided as a “layer” of income as shown below. Point A on the illustration is the date of Dan’s death. Point B is the date on which Billy becomes age 16 and his mother’s Social Security benefit ends. Point C is the date on which Billy becomes age 18 and his Social Security benefit ends and the widow’s “blackout period” begins. Point D is the date on which Susan’s Social Security benefit resumes at her age 60 and the blackout period ends. Point E is the assumed date of Susan’s death. | | | | | |
|  |  | C | D |  |
|  |  | C |  | E |
|  | B |  |  | E |
| A |  |  |  | E |
| Dan’s  Death  Occurs | Billy’s  Age  16 | Billy’s  Age  18 | Blackout  Period  Ends | Susan’s  Death  Occurs |

You will remember that beginning on the date that Dan dies and until Susan’s benefit ceases at Billy’s age 16—the period shown as AB—the family needs an additional $15,500 each year to supplement Social Security benefits to bring the family’s income to $45,500. By looking at the graphic illustration of the family’s income need, however, we can see that this additional income is actually needed until Susan’s death—the period shown as AE. That’s the first layer. The amount of capital needed at 5% to produce $15,500 each year is $310,000. ($310,000 X 5% = $15,500)

When Susan’s Social Security benefit ceases at Billy’s age 16, an additional $15,000 of income must be provided throughout Susan’s lifetime—the period shown as BE. This will require capital of $300,000. However, that capital isn’t needed for another eight years, so they only need the discounted, or present, value of that $300,000 today. The discounted value of $300,000 at 5% needed in 8 years is $203,044. (See Appendix B)

By the time that Billy is age 16, the income provided by Social Security has declined to $15,000. The total supplemental income amount that needs to be provided starting at Billy’s age 16 is $30,500. The first $15,500 of supplemental income began at Dan’s death; the second $15,000 of supplemental income began when Susan’s Social Security benefit ceased. That’s the second layer.

When Billy’s Social Security benefit of $15,000 ceases at his age 18, it needs to be made up through supplemental income. However, since Susan’s Social Security benefits begin again at her age 60 and amount to $14,400 a year, only $600 of the $15,000 needs to last throughout her life. The other $14,400 of supplemental income needs to last only from the time that Billy’s Social Security benefit ends and Susan’s begins—a period from Susan’s age 40 to her age 60 or the period shown as CD.

The $600 of annual income for the period CE requires $12,000 of capital invested at 5%. However, since we don’t need the $12,000 until Susan is age 40—10 years from now—we can use the 5%/10 year discount factor of .6139 to discover that we only need $7,367 of capital today to provide the $12,000 of capital in 10 years.

Finally, we need to provide the additional $14,400 for the 20-year period from Susan’s age 40 until she is age 60 and Social Security benefits begin again. By looking at the present value of an annuity table in Appendix A, we can see that we need $12.4622 dollars at the beginning of a 20-year period at 5% to provide $1 for each of those 20 years. Since we need to provide $14,400, we just need to multiply it by 12.4622 to see the amount of capital we need at the beginning of the period. The amount needed, of course, is $179,456.

Since we won’t need the $179,456 for 10 years, i.e. when Susan becomes age 40, we can discount it. At a 5% discount rate for 10 years, the factor that we need to use is .6139. By multiplying $179,456 by .6139, we see that the amount of capital needed today to produce the $14,400 of income is $110,168.

A recap of the income needed during each period and the amount of current capital needed to provide it using the capital retention approach yields the following:

|  |  |  |  |
| --- | --- | --- | --- |
| From | To | Income Needed | Capital Needed |
| Dan’s death | Susan’s death | $15,500 each year | $310,000 |
| Billy’s age 16 | Susan’s death | $15,000 each year | $203,044 |
| Billy’s age 18 | Susan’s death | $ 600 each year | $ 7,367 |
| Billy’s age 18 | Susan’s age 60 | $14,400 each year | $110,168 |
| Total current capital needed | | | $630,579 |

## Summary

In addition to the lump-sum cash needs that survivors have following the death of a breadwinner, survivors normally must replace some or all of the breadwinner’s earnings. Since there are only two methods of producing income: people at work and money at work, the surviving spouse generally has a choice. That choice is to use existing assets to provide investment income or increase earned income by entering the job market or increasing the time worked outside the home.

The more satisfactory method of producing survivor income—especially when there are minor children—is through investment income. It enables the surviving parent to remain at home (or limit employment to part-time) ***and*** it does not cause a reduction in Social Security benefits. That income needs to address the particular financial needs of three periods: the dependency period, the blackout period and the retirement period.

## Test Your Comprehension

1. Bob wants to provide a $60,000 annual income to Sharon for four years beginning two years after his death to enable her to return to the university and obtain a Ph.D. Assuming Bob and Sharon have no current life insurance or liquid assets, how much life insurance is needed to accomplish his objective assuming a 3% interest rate and liquidation of capital and interest?

$210,224

$240,000

$223,026

$216,536.

2. Which of the following is NOT a drawback of the liquidation of principal to produce survivor income?

1. Surviving children may receive no inheritance.
2. Capital may be depleted before the surviving spouse’s death.
3. Additional capital is generally needed when compared with the capital retention method
4. Compensating for inflation may be difficult.

# Glossary

**Blackout period**—The blackout period is that period during which the surviving spouse is entitled to no Social Security benefits. That period normally begins for surviving spouses when there is no child of the deceased worker under age 18 who is entitled to a child’s benefit. The blackout period normally ends for surviving spouses when his or her Widow’s & Widower’s benefits begin at age 60.

**Capital retention approach**—The fundamental concept in capital retention is that sufficient capital must be provided so that the required income can be produced solely through investment earnings—rather than through investment earnings combined with liquidated principal.

**Capitalized value of net earnings**—The amount of capital needed, at a given interest rate, to replace an individual’s net earnings.

**Child’s benefit**—Child’s benefit is a monthly Social Security benefit for each child who is under age 18 (under age 19 if attending elementary or high school).

**Currently insured**—A worker is currently insured, for Social Security purposes, when he or she has accrued a total of at least 6 quarters of coverage during the 13-quarter period ending with the calendar quarter in which the worker died.

**Dependency period**—The dependency period is that period of time that begins at the death of the breadwinner with minor children and ends when the youngest child is age 18 (age 19 if the child is attending elementary or high school). Because of minor children, the income needed during the dependency period is likely to be the highest.

**Discount rate**—The discount rate used in determining present value is the annual rate of return that could be earned currently on an investment.

**Estate settlement costs**—Estate settlement costs are those costs associated with the settlement of a decedent’s estate. They include executors’, attorneys’ and appraisers’ fees and other expenses.

**Fully insured**—A worker is fully insured, for Social Security purposes, when he or she has accrued a total of 40 quarters of coverage. Once a worker becomes fully insured, that status continues throughout the worker’s lifetime.

**Human life value approach**—The human life value approach to the determination of life insurance requirements represented an early attempt to assign a particular life insurance amount to an individual’s situation, based on his or her earning capacity and existence of dependents. It involves the estimating of an individual’s personal earnings each year to retirement, from which the costs of self-maintenance, life insurance premiums and income taxes are deducted to produce residual income. The residual income stream is then discounted to its present value. The present value of that residual income stream is the value of that human life.

**Mother or Father’s Benefit**—A Mother’s or Father’s benefit is a monthly benefit for a widow or widower who is caring for at least one child under the age of 16.

**Open-ended question**—An open-ended question is a question that can’t be answered by a “yes” or “no.” Open-ended questions usually as who, why, what or how.

**Present value**—The present value is the current value of a future sum discounted at some interest rate, also known as a discount rate.

**Primary Insurance Amount (PIA)**—The Primary Insurance Amount is the basic unit used to determine the amount of each monthly benefit payable under Social Security. The Primary Insurance Amount is based on the worker’s earnings and is the benefit that a worker would receive at the normal retirement age.

**Quarter of coverage**—A quarter of coverage is accrued, for Social Security purposes, when a worker that participates in Social Security earns a specific amount of income. For 2015, a quarter of coverage is accrued—to a maximum of four each calendar year—when a worker earns $1,220.

**Responsive listening**—Responsive listening requires that the listener respond to the person who is speaking. This response usually takes the form of: nodding approval, verbalizing agreement by saying “I understand how you feel” and paraphrasing the prospect’s statements.

# Appendix A

## Present Value Factor for Annuity Table

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Annuity | | | | | | | |
| Years | 2% | 3% | 4% | 5% | 6% | 7% | 8% |
| 1  2  3  4  5  6  7  8  9  10  11  12  13  14  15  16  17  18  19  20  25  30  40 | 0.9804  1.9416  2.8839  3.8077  4.7135  5.6014  6.4720  7.3255  8.1622  8.9826  9.7868  10.5753  11.3484  12.1062  12.8493  13.5777  14.2919  14.9920  15.6785  16.3514  19.5235  22.3965  27.3555 | 0.9709  1.9135  2.8286  3.7171  4.5797  5.4172  6.2303  7.0197  7.7861  8.5302  9.2526  9.9540  10.6350  11.2961  11.9379  12.5611  13.1661  13.7535  14.3238  14.8775  17.4131  19.6004  23.1148 | 0.9615  1.8861  2.7751  3.6299  4.4518  5.2421  6.0021  6.7327  7.4353  8.1109  8.7605  9.3851  9.9856  10.5631  11.1184  11.6523  12.1657  12.6593  13.1339  13.5903  15.6221  17.2920  19.7928 | 0.9524  1.8594  2.7232  3.5460  4.3295  5.0757  5.7864  6.4632  7.1078  7.7217  8.3064  8.8633  9.3936  9.8986  10.3797  10.8378  11.2741  11.6896  12.0853  12.4622  14.0939  15.3725  17.1591 | 0.9434  1.8334  2.6730  3.4651  4.2124  4.9173  5.5824  6.2098  6.8017  7.3601  7.8869  8.3838  8.8527  9.2950  9.7122  10.1059  10.4773  10.8276  11.1581  11.4699  12.7834  13.7648  15.0463 | 0.9346  1.8080  2.6243  3.3872  4.1002  4.7665  5.3893  5.9713  6.5152  7.0236  7.4987  7.9427  8.3577  8.7455  9.1079  9.4466  9.7632  10.0591  10.3356  10.5940  11.6536  12.4090  13.3317 | 0.9259  1.7833  2.5771  3.3121  3.9927  4.6229  5.2064  5.7466  6.2469  6.7101  7.1390  7.5361  7.9038  8.2442  8.5595  8.8514  9.1216  9.3719  9.6036  9.8181  10.6748  11.2578  11.9246 |

# Appendix B

## Present Value Factor for Single Sum Table

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
| Present Value Factor for a $1 Future Lump Sum | | | | | | | |
| Years | 2% | 3% | 4% | 5% | 6% | 7% | 8% |
| 1  2  3  4  5  6  7  8  9  10  11  12  13  14  15  16  17  18  19  20  25  30  40 | .9804  .9612  .9423  .9238  .9057  .8880  .8706  .8535  .8368  .8203  .8043  .7885  .7730  .7579  .7430  .7284  .7142  .7002  .6864  .6730  .6095  .5521  .4529 | .9709  .9426  .9151  .8885  .8626  .8375  .8131  .7894  .7664  .7441  .7224  .7014  .6810  .6611  .6419  .6232  .6050  .5874  .5703  .5537  .4776  .4120  .3066 | .9615  .9246  .8890  .8548  .8219  .7903  .7599  .7307  .7026  .6756  .6496  .6246  .6006  .5775  .5553  .5339  .5134  .4936  .4746  .4546  .3751  .3038  .2083 | .9524  .9070  .8638  .8227  .7835  .7462  .7107  .6768  .6446  .6139  .5847  .5568  .5303  .5051  .4810  .4581  .4363  .4155  .3957  .3769  .2953  .2314  .1420 | .9434  .8900  .8396  .7921  .7473  .7050  .6651  .6274  .5919  .5584  .5268  .4970  .4688  .4423  .4173  .3936  .3714  .3503  .3305  .3118  .2330  .1741  .0972 | .9346  .8734  .8163  .7629  .7130  .6663  .6227  .5820  .5439  .5083  .4751  .4440  .4150  .3878  .3624  .3387  .3166  .2959  .2765  .2584  .1842  .1314  .0668 | .9259  .8573  .7938  .7350  .6806  .6302  .5835  .5403  .5002  .4632  .4289  .3971  .3677  .3405  .3152  .2919  .2703  .2502  .2317  .2145  .1460  .0994  .0460 |

# Answers to Chapter Quizzes

## Chapter 1

Question 1 Feedback

1. Your answer is incorrect. To determine an individual’s human life value using the human life value method requires that you estimate average annual earnings over his or her working life, deduct from that number a) the total annual state and federal income taxes paid, b) the life insurance premiums paid and c) the annual amount the individual uses to maintain himself or herself. Then, obtain the present value of that net amount using an appropriate discount rate. To obtain the answer you chose, you used the present value factor for 30 years instead of the 25 years remaining in John’s working life. Please try again.
2. Your answer is correct. To determine an individual’s human life value using the human life value method requires that you estimate average annual earnings over his or her working life, deduct from that number a) the total annual state and federal income taxes paid, b) the life insurance premiums paid and c) the annual amount the individual uses to maintain himself or herself. Then, obtain the present value of that net amount using an appropriate discount rate. In this case, the net amount is $48, 200 ($60,000 - $6,000 - $600 - $5,200 = $48,200). Since the present value factor is 17.4131, the correct answer is $839,311. ($48,200 *x* 17.4131 = $839,311)
3. Your answer is incorrect. To determine an individual’s human life value using the human life value method requires that you estimate average annual earnings over his or her working life, deduct from that number a) the total annual state and federal income taxes paid, b) the life insurance premiums paid and c) the annual amount the individual uses to maintain himself or herself. Then, obtain the present value of that net amount using an appropriate discount rate. To obtain the answer you chose, you deducted the taxes and insurance premiums John paid, but you didn’t deduct the portion of his earnings that he used to maintain himself. Please try again.
4. Your answer is incorrect. To determine an individual’s human life value using the human life value method requires that you estimate average annual earnings over his or her working life, deduct from that number a) the total annual state and federal income taxes paid, b) the life insurance premiums paid and c) the annual amount the individual uses to maintain himself or herself. Then, obtain the present value of that net amount using an appropriate discount rate. To obtain the answer you chose, you multiplied John’s net annual amount by the number of years until he retires. Instead, you should have used the present value factor for 25 years. Please try again.

Question 2 Feedback

1. Your answer is incorrect. That *is* an identified flaw of the human life value method. The human life value approach to calculating life insurance needs is an attempt to use a one-size-fits-all method for calculating financial needs of individuals and families that may be very different from one another. Please try again.
2. Your answer is incorrect. That *is* a flaw that has been identified. Under the human life value method of determining insurance needs the individual’s human life value—and the resulting life insurance need—is shown as declining as he or she ages, despite the fact that an individual’s life insurance need does not always decline with advancing age and may actually increase depending on individual circumstances. Please try again.
3. Your answer is correct. That the human life value method calculates a personal life insurance need for individuals with no dependents is not a flaw of the system. In fact, the use of the method to determine personal life insurance needs requires that others depend on the insured’s earning capacity.
4. Your answer is incorrect. That *is* a human life value method flaw. The human life value approach calculates the funds needed to ensure a family’s future without regard to its actual needs. That the amount of life insurance thus calculated is appropriate for any individual and his or her family is likely to be coincidental. Please try again.

Question 3 Feedback

1. Your answer is correct. The insurance needs analysis method of determining an individual’s life insurance needs is more realistic than the human life value approach because it deals with specific needs.
2. Your answer is incorrect. An important characteristic of insurance needs analysis is its sensitivity to the financial differences that exist between families. Please try again.
3. Your answer is incorrect. Since the insurance needs analysis method of determining appropriate life insurance amounts uses actual family needs, it tends not to rely on an average of the amount of allocated earnings. Please try again.
4. Your answer is incorrect. Precisely because it relates life insurance amounts to specific individual and family financial needs, the insurance needs analysis method of determining appropriate life insurance amounts is normally far more meaningful to clients than the human life value method. Please try again.

## Chapter 2

Question 1 Feedback

a. Your answer is incorrect. Information concerning the individual’s current income *is* required in order to determine the appropriate amount of life insurance. For the surviving family members to continue to enjoy the standard of living that they had before the breadwinner’s death, the breadwinner’s income must be replaced. So it’s critical to know just what that income is. Please try again.

b. Your answer is correct. Although information about an individual’s tolerance for risk should be obtained during a data-gathering session, such information helps determine the *type* of life insurance that is suitable, rather than the amount of life insurance that should be recommenced.

c. Your answer is incorrect. Information concerning an individual’s assets and liabilities *is* needed to establish the appropriate amount of life insurance needed by an individual. Please try again.

d. Your answer is incorrect. Information about an individual’s goals and objectives—things he or she wants to accomplish—*must be* obtained since life insurance is often the fuel that enables surviving family members to achieve their goals. Please try again.

Question 2 Feedback

Your answer is incorrect. Although an individual insurer may impose underwriting guidelines that restrict a certain type of life insurance—high early cash value plans, for example—only to applicants with earnings that are at least a specified amount, such restrictions are unusual and are not the purpose of determining an individual’s current income. Please try again.

Your answer is correct. An important objective of life insurance planning is to ensure that survivors can maintain their standard of living despite the death of a breadwinner. Most families live primarily on their earned income rather than on their assets. For the surviving family members to continue to enjoy the standard of living that they had before the breadwinner’s death, the breadwinner’s income must be replaced. So it’s critical to know just what that income is.

Your answer is incorrect. While insurers certainly collect statistical data for purposes of mortality studies, etc., such studies involving consumer income are relatively insignificant and not an important reason for collecting information about an individual’s current income. Please try again.

Your answer is incorrect. Although an individual’s current income may impact his or her ability to afford the coverage proposed, assets may also be the source of premium payments. In any case, determining the individual’s current income is not principally for purposes of assessing how much premium can be afforded. Please try again.

Question 3 Feedback

1. Your answer is incorrect. The extent of a proposed insured’s liquid assets *does* generally reduce the amount of life insurance needed to meet personal and family requirements. For example, if $500,000 is required to replace the prospect’s income, and he or she has already accumulated $150,000 in savings or investments, only $350,000 of life insurance may be necessary to meet the individual’s needs. Please try again.
2. Your answer is incorrect. A large amount of accumulated assets generally increases probate costs and may also increase the need for life insurance protection if the extent of such assets results in the imposition of federal estate taxes and other taxes at death. The assets owned by the prospect at death become a part of his or her estate for tax purposes. Depending upon the size of those assets, estate settlement costs and taxes approaching 40 percent may be due within nine months of death—thereby increasing the prospect’s life insurance need. Please try again.
3. Your answer is incorrect. The applicant’s assets may be the only viable source for life insurance premium payments, especially when the life insurance need is large. It is not unusual for a wealthy client to employ the strategy of making annual gifts of existing assets to pay premiums on life insurance owned by a trust or by adult children. Please try again.
4. Your answer is correct. Although insurers generally will not issue large amounts of life insurance if no demonstrable need for it exists, the level of an applicant’s accumulated assets alone does not preclude the issuance of life insurance.

## Chapter 3

Question 1 Feedback

1. Your answer is correct. A surviving family’s immediate cash needs at a breadwinner’s death generally include those cash needs that must be satisfied within the first nine months. Education costs, although important to provide for, may not become an issue for many years following death and are not normally considered part of the immediate cash needs.
2. Your answer is incorrect. Burial expenses *are* included as part of a surviving family’s immediate cash needs. The funds needed to pay burial and funeral expenses can be substantial. They may amount to $5,000 to $12,000 for an average funeral and much more for a lavish one. Please try again.
3. Your answer is incorrect. Federal estate taxes *are* included as part of immediate cash needs in cases involving the likely payment of such taxes. Depending on the extent of the decedent’s estate, federal estate taxes may amount to 40 percent of the value of the estate and are generally due in cash nine months after the date of death. In addition to federal estate taxes, many states also levy inheritance or estate taxes. Please try again.
4. Your answer is incorrect. Unreimbursed hospital costs *are* part of the immediate cash needs. Often as much as 70 percent of an individual’s lifetime medical expenses are incurred in a final illness. While it is impossible to determine exactly how much will not be reimbursed by insurance, it is important for the individual to consider this cost in his or her insurance planning. Please try again.

Question 2 Feedback

1. Your answer is incorrect. An emergency fund should be considered a fund designed to help replace the flexibility that the family had when the breadwinner was alive. It is often used to pay for major medical emergencies and to make large repairs or replace major items. A sum as small as $10,000 could easily be exhausted in paying for a single medical emergency or in making a large home repair. Please try again.
2. Your answer is incorrect. In addition to medical emergencies, the cost of certain large repairs or replacements are usually considered in determining the proper size of emergency fund, including home repairs, major appliance replacement and automobile repairs or replacement. An emergency fund amounting to a single month’s income is likely to be far too little for most families. Please try again.
3. Your answer is correct. The emergency fund is normally used to pay for medical emergencies, to make major repairs to or to replace the survivors’ house, cars, and major appliances. As a general guideline, many financial practitioners use six months of income as a target for emergency funds.
4. Your answer is incorrect. Allocating a specific dollar amount as an emergency fund irrespective of the family’s income, lifestyle and spending habits is generally a poor idea. Furthermore, $15,000 is not likely to last very long when used to replace or repair major appliances, automobiles or the family home. Please try again.

## Chapter 4

Question 1 Feedback

1. Your answer is correct. For benefits to be payable to a surviving spouse under the widow’s and widower’s benefit, the deceased worker must have been fully insured. A widow or widower’s Social Security benefit is not payable if the deceased worker had been only currently insured.
2. Your answer is incorrect. Lump-sum Social Security death benefits of $255 are payable upon the death of a covered worker, regardless of whether the worker is currently insured or fully insured. Please try again.
3. Your answer is incorrect. A Social Security mother’s or father’s benefit is payable to a surviving spouse of a covered worker who was currently or fully insured provided the criteria for payment are met. Please try again.
4. Your answer is incorrect. For the child of a deceased covered worker to receive a child’s benefit, the worker must have been either currently insured or fully insured. Please try again.

Question 2 Feedback

1. Your answer is incorrect. That *is* a criterion that must be met. In order for a surviving spouse of a deceased covered worker to receive a widow’s and widower’s benefit under Social Security, the deceased worker must have been fully insured. The surviving spouse of a currently insured worker is not eligible for a Social Security widow’s and widower’s benefit. Please try again.
2. Your answer is incorrect. That *is* a criterion that must be met. A non-disabled surviving spouse of a deceased covered worker must be at least age 60 to be eligible for a Social Security widow’s and widower’s benefit. Please try again.
3. Your answer is incorrect. That *is* a criterion that must be met. The surviving spouse of a deceased covered worker must not be remarried before reaching age 60 unless such marriage ends. Please try again.
4. Your answer is correct. Although a surviving spouse’s receipt of earned income may affect the amount of Social Security widow’s and widower’s benefit that is received, the simple receipt of such earned income does not make the surviving spouse ineligible to receive the benefit.

Question 3 Feedback

1. Your answer is incorrect. The only element of her total income that will affect Sharon’s Social Security benefit is her *earned income*; income from other sources has no effect on it. Please try again.
2. Your answer is incorrect. Sharon’s Social Security mother’s or father’s benefit is reduced by any excess earned income. Since Sharon’s earned income is in excess of the specified threshold for 2015, her benefit will be reduced. Please try again.
3. Your answer is correct. Sharon’s Social Security mother’s or father’s benefit is reduced $1 for every $2 of excess earned income received. In 2015, excess earned income is any earned income over $15,720. Thus, her $12,000 annual Social Security mother’s or father’s benefit is reduced by $5,000, thereby reducing her benefit to $7,000 in 2015. ($25,720 - $15,720 = $10,000 excess earnings; $10,000 ÷ 2 = $5,000 benefit reduction)
4. Your answer is incorrect. Sharon’s Social Security mother’s or father’s benefit is reduced by any excess *earned income* but not by any unearned income, such as dividends, capital gains or interest. Please try again.

## Chapter 5

Question 1 Feedback

1. Your answer is incorrect. A mother’s or father’s Social Security benefit does not end when the oldest child reaches age 16. Please try again.
2. Your answer is incorrect. A mother’s or father’s Social Security benefit does not end when the oldest child reaches age 18. Please try again.
3. Your answer is correct. A mother’s or father’s Social Security benefit ends when the youngest child of a surviving spouse reaches age 16. Since Edna’s youngest child is age 12, that limiting age will occur in four years.
4. Your answer is incorrect. A mother’s or father’s Social Security benefit does not end when the youngest child reaches age 18. Please try again.

Question 2 Feedback

1. Your answer is correct. The Social Security blackout period begins when the youngest child of a surviving spouse attains age 18 (or 19 if in elementary or high school); it continues until Social Security benefits recommence, which may be as early as the surviving spouse’s age 60. Because Audrey’s youngest child is age 12 at the time she is age 46, all dependency period benefits will end in six years when the child is 18 and she is age 52. Since Social Security retirement benefits may begin for Audrey at her age 60, the shortest blackout period she may experience is eight years.
2. Your answer is incorrect. In order for Audrey’s shortest blackout period to be thirteen years, all dependency period Social Security benefits would have to end when her oldest child reaches age 16. That is not the case, however. Such benefits end when her youngest child reaches age 18. Please try again.
3. Your answer is incorrect. In order for Audrey’s shortest blackout period to be eleven years, all dependency period Social Security benefits would have to end when her oldest child reaches age 18. That is not the case, however. Such benefits end when her *youngest* child reaches age 18. Please try again.
4. Your answer is incorrect. In order for Audrey’s shortest blackout period to be ten years, all dependency period Social Security benefits would have to end when her youngest child reaches age 16. That is not the case, however. Such benefits end when her youngest child reaches age 18. Please try again.

Question 3 Feedback

1. Your answer is incorrect. The reduction in Social Security benefits due to the beneficiary’s receipt of earned income prior to full retirement age is equal to $1 for each $2 earned in excess of a specified amount. The specified amount generally changes annually and, for 2015, is $15,720. Cindy reached her full retirement age last year, however. Please try again.
2. Your answer is correct. The reduction in Social Security benefits due to the beneficiary’s receipt of earned income prior to full retirement age is equal to $1 for each $2 earned in excess of a specified amount. The specified amount generally changes annually and, for 2015, is $15,720. At full retirement age, no Social Security benefit reduction for earned income occurs. Since Cindy reached her full retirement age for Social Security last year, she would experience no reduction in her Social Security benefit due to her earned income.
3. Your answer is incorrect. When a reduction in Social Security benefits applies due to the beneficiary’s receipt of income, that reduction is based solely on *earned* income in excess of a specified amount. Your answer indicates you based a reduction on Cindy’s unearned income. Please try again.
4. Your answer is incorrect. When a reduction in Social Security benefits applies due to the beneficiary’s receipt of income, that reduction is based solely on *earned* income in excess of a specified amount. Your answer indicates you based a reduction on Cindy’s earned income and unearned income. Please try again.

## Chapter 6

Question 1 Feedback

1. Your answer is correct. To determine the amount of capital required at the beginning of the period, calculate the present value of the $60,000 yearly for 4 years. Using a 3 percent assumption and applying it to the compound discount table for $1 annuity in Appendix A, we can see that the factor used to determine the present value of the 4 years of income is 3.7171. Now that we know the present-value factor, multiply the $60,000 needed annual income by the factor. This will tell us how much capital we need at the beginning of the 4-year period to produce the income: the amount of money needed to produce $60,000 each year at 3 percent is $223,026 ($60,000 *x* 3.7171 = $223,026). Since the income is not required for two years, we can further discount the capital needed. Using the *present value of a future lump sum* shown in Appendix B, we can see the present value factor that we should use at a 3% compounding rate to determine the capital we need today to produce the lump sum needed in two years is .9426. Multiplying the $223,026 by the factor gives us the amount needed at Bob’s death: $210,224. ($223,026 *x* .9426 = $210,224)
2. Your answer is incorrect. Your selection indicates you added the four years of income together to obtain your answer. You need to determine the present value of the $60,000 annual income stream. Please try again.
3. Your answer is incorrect. Your answer indicates that you determined the present value of the $60,000 stream of income. However, since the funds needed to provide the income are not required immediately, you need to further discount that amount. Please try again.
4. Your answer is incorrect. Your answer indicates that you determined the present value of the required income stream but only discounted that lump-sum amount for one year. Please try again.

Question 2 Feedback

* 1. Your answer is incorrect. The possible loss of an inheritance from the funds used to provide survivor income *is* a drawback to the use of both principal and interest to produce income for survivors. Depending on when a surviving spouse dies there may be no remaining principal to pass on to surviving children. Please try again.
  2. Your answer is incorrect. That the capital being liquidated to provide income may be depleted, resulting in a cessation of survivor income *is* a drawback to using principal and interest to provide income. If the spouse lives beyond life expectancy or anticipated interest levels are not realized, there may be no remaining capital to provide income. Please try again.
  3. Your answer is correct. The need for additional capital, i.e. additional life insurance, when assuming that principal and interest will be used to provide income for survivors is not a drawback. In fact, just the opposite is true: less capital (or life insurance) is required when income is assumed to be produced from interest *plus* the liquidation of principal rather than if income were to be based solely upon interest earnings.
  4. Your answer is incorrect. The inability to increase income—without possible adverse results—to overcome the loss of purchasing power resulting from inflation *is* a drawback to using principal and interest to generate income. Because survivors must use the principal in addition to the earnings on it to produce income, they are usually unable to adjust their income to make up for the buying power erosion resulting from inflation. Please try again.

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1. One dollar due 10 years from today is worth less than one dollar due right now. A compound discount table enables you to determine the value of that dollar due in the future. [↑](#footnote-ref-1)