Life Assurance Online

Consumer Guide

To

Life Insurance

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INTRODUCTION

This booklet is intended as a general guide to life insurance to help you understand what types of policies are available and in what circumstances they are commonly used.

It covers life insurance used for protection purposes and does not include other types of life insurance policies such as investment bonds, endowments or life insurance savings plans.

The booklet covers some of the more common additional features available on most plans, the benefits of setting up a policy in Trust and general taxation issues. The last section gives a glossary of terms to help you understand some of the jargon.

The guide is not intended to give financial advice under the Financial Services and Markets Act 2000 or the rules and regulations of the Financial Services Authority. If you are in any doubt you should seek professional advice from an Independent Financial Adviser.

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Please note that the guide is intended for the use of UK residents and British expats. We hope you will find it useful. For further information and a quotation please go back to our web site at http://www.lifeassuranceonline.co.uk

PROTECTING YOUR MORTGAGE

Life insurance is commonly used to protect the outstanding loan on a mortgage. The type of plan used will depend on the type of mortgage you have.

What type of mortgage do you have?

If you have a mortgage where you are repaying both the capital and the interest on the loan every month you have a ***capital repayment mortgage***. With this type of mortgage the outstanding capital on the loan is reducing each month so that by the end of the mortgage term the loan has been paid in full.

If your mortgage is set up to repay only the interest every month then you have an ***interest only mortgage***. With this type of mortgage the outstanding loan stays the same throughout the term of the mortgage. With this arrangement you would also have an investment savings plan designed to accumulate sufficient capital to repay the loan at the end of the mortgage term and separate life cover.

What type of plan should I use?

If you have a ***capital repayment mortgage*** you would normally use a ***decreasing term life insurance plan***. This is one where the sum insured decreases every year in line with the decreasing loan outstanding on the mortgage.

If you have an ***interest only mortgage*** you would normally use a ***level term life insurance plan.*** This is one where the sum insured stays the same throughout the life of the plan.

With both types of plans the cost covers the risk of you dying prematurely and in the event of a claim provides funds to pay off the outstanding loan. When the policy comes to an end it ceases without value.

What additional features are available?

The most common additional features are critical illness cover, premium protection, terminal illness and conversion.
Critical illness cover can be added with most company's plans as an option. In this case the plan will pay out either on death or critical

illness. There is an additional cost to this option.

Premium protection or “waiver of premium” is also available and provides for protection of the monthly or annual premium. If you are ill and unable to work the insurance company will pay or “waive” the premium until you return to work.

The benefit can be claimed after a deferred period, normally 6 months. There is an additional cost to this option and will normally depend on your state of health and occupation at the time of application.

Terminal illness cover is now available on most plans as standard and does not involve any additional cost. The benefit can be claimed if you are unlikely to survive a terminal illness for more than 12 months.

PROTECTING YOUR FAMILY

Life insurance plans are commonly used to provide financial protection for a surviving partner in the event of premature death.

What type of plan should I use?

This will depend on your personal financial circumstances and objectives. ***Term life insurance***, ***family income benefit*** and ***whole life insurance plans*** are most commonly used.

Below is an example of where life insurance could be used to provide the protection needed:

John is married and aged 28. He has 2 children aged 4 and 6. His wife does not work as her time is spent looking after the children. They have a mortgage in their joint names that is covered by a separate life insurance policy. John is concerned that if he should die prematurely the loss of his income would bring financial hardship to the family.

John recognises that the critical period where the family is at most risk is the number of years before his youngest child becomes financially independent. John has decided to take out life insurance cover on his own life for 17 years as he hopes his youngest child will go in to higher education. He has decided to use a ***level term life insurance plan.***

How much should I insure for?

This will depend on your personal financial circumstances and what you want to achieve. Below is a list of some of the things you would normally take in to account:

- The level of income your surviving partner would need
- How long would that income be required for?
- The amount of debt not covered by life insurance
- The amount of family savings and investments
- How much can you afford each month from your disposable income?
- Other life insurance policies you might have

This list is only a guide to some of the issues you should consider. Professional advice should be taken through an Independent Financial Adviser to ensure that you choose the right policy to meet your needs.

PROTECTING YOUR ESTATE

A life insurance policy can be used to provide funds to meet a potential inheritance tax liability. This arrangement thereby allows more family assets to be passed on to your heirs rather than the Inland Revenue.

When does the tax arise?

Inheritance tax is potentially payable if the value of your estate at death goes over a certain amount. This is subject to change in the budget each year and is currently (2010/2011) £325,000.

For a married couple the potential liability arises only on the death of the survivor, not the first to die. For a single person it arises on their death. The tax bill normally has to be paid before probate can be granted. This could mean that a loan has to be taken out before family assets can be sold to pay the bill.

How does life insurance help?

One solution to meeting the liability is to use a life insurance policy to provide the capital at death to pay the tax bill. The proceeds from the policy are paid free of tax. The plan is set up under a Trust so does not form part of the deceased's estate for inheritance tax purposes.

The funds are paid to the Trustees of the Trust who then pass them on to the beneficiary(s) to meet the tax bill. As the policy is in Trust, probate does not have to be proven, so the funds can normally be paid by the insurance company within a few days of a claim.

What type of policy is used?

In the case of a married couple a ***whole life insurance policy*** is used which is set up in joint names and payable only on the last to die. For a single person a whole life insurance policy would also be used and set up in his/her sole name.

In both cases the plan is set up in Trust and the beneficiaries are normally the heirs to the estate. In most cases this would be the children of the deceased and or other family members.

Life-time gifts

A life insurance policy can also be used to protect life time gifts from inheritance tax.

For example, another way of reducing a potential liability to inheritance tax is for the deceased to make a gift of assets during his/her life thereby reducing the value of the estate at death.

Such gifts are termed “gifts inter vivos” and subject to certain conditions become “potentially” exempt from inheritance tax on death. To become exempt the donor has to survive 7 years from the date of making the gift.

During the 7 year period there is a risk that the donor could die and thereby render the gift liable to inheritance tax. A simple solution to this problem is for the donor to take out a life insurance policy to provide funds to meet the potential liability.

This special type of policy is called a “gifts inter vivos” policy and is set to run for 7 years. The sum insured reduces each year in line with the sliding tax scale. For example, the tax liability in the 3rd year is higher than the 6th year.

The policy is also set up in Trust to ensure that the funds are paid outside the donors’ estate. The beneficiary(s) would normally be the heirs to the estate.

Inheritance tax is a complex area and tax laws are always liable to change. You should seek professional advice from an Independent Financial Adviser.

PROTECTING YOUR BUSINESS

Life insurance policies can provide valuable protection for a business and a benefit for employees.

What arrangements are available?

The main types of arrangement are designed to protect the interest of shareholder directors of a close company, partners in a business partnership, key employees and a business loan.

Director shareholder schemes

Shareholder directors in a close limited company (ie 5 or less directors) have an interest in protecting their company from the shares coming in to the hands of potential competitors.

This can arise if a director shareholder dies and his/her shares are subsequently sold by the heir of his/her estate to a director of a competitive company.

To overcome this problem, director shareholders can set up a legally binding arrangement whereby the surviving shareholder directors have the first option to buy back the shares of the deceased shareholder director.

A life insurance policy can be set up to provide the funds to buy back the shares to prevent them falling in to the hands of a competitor. In this situation each director shareholder is deemed to have an insurable interest in the lives of the others.

A ***term life insurance policy*** is normally used with the sum insured reflecting the assessed value of each directors holding. Each shareholder takes out a separate policy for the benefit of all the other shareholder directors.

In the event of premature death the funds are provided to enable the remaining shareholders to buy back the shares, thereby protecting the interests of the remaining shareholders and the company from potential competitors acquiring the shares.

Partnership schemes

A similar situation arises with the partners of a business partnership. In this case it is the partners share of the business which is protected. As a result, a special partnership scheme can be established so that life insurance policies can provide the funds for the surviving partners to buy back the deceased partners share of the business.

Keyperson arrangements

A keyperson in a business is one who provides specialised knowledge or a contribution to the business which would be difficult to replace. If the keyperson were to die prematurely the business could suffer financial loss.

In this situation the business has an insurable interest in the keyperson and can take out a life insurance policy to protect it's interests. Normally a ***term life insurance policy*** is used with the business as the legal owner and therefore entitled to the proceeds of a claim.

Employee arrangements

Although not directly protecting business assets, a life insurance policy is commonly used to provide a death in service benefit for selected employees.

The life insurance is taken out by the employer for the benefit of the employee. The sum insured is usually a multiple of his annual salary and the Inland Revenue allows up to 4 times salary as a maximum.

The arrangement can be set up as a single stand alone policy or where many employees are involved a group scheme is usually arranged. ***Level term life insurance*** is normally used. The benefit is not taxed as a benefit in kind to the employee but the company receives corporation tax relief on the premiums.

ADDITIONAL PLAN FEATURES AND BENEFITS

Most life insurance plans have options available which can provide additional benefits for the life insured. These options must be selected at the time of making the application as they cannot be added later. The most common options are listed below.

Waiver of premium

Sometimes also known as premium protection. This option provides for the ongoing payment of the premium if the policyholder suffers long term illness/disability and loses his/her income as a result.

The option can be set up to cover the policyholder for loss of income from their own occupation or any occupation. There is a waiting period before a claim can be made. This is referred to as the "deferred period" and is normally 6 months but other periods are available.

Underwriting for this option is more strict than for life cover and will take in to account your occupation as well as health. In most cases the option involves a relatively small additional cost.

Indexation

This option is designed to minimise the effects of inflation reducing the real value of the sum insured. Under this facility the amount insured at outset increases each year, normally in line with the Retail Price Index (RPI), the Average Earnings Index (AEI) or a fixed percentage.

At the same time the premium also increases each year by whatever the sum insured increase is based on. Although the option has to be chosen at outset it can be cancelled at any time but cannot normally be reinstated.

Conversion

A life insurance policy can be set up with the option at the end of the policy to convert it to a ***whole life plan*** or ***endowment*** for the same sum assured without the need to provide further details of health.
There is an additional cost involved for this option but it can be a useful benefit where the policyholders' health has deteriorated since the policy was taken out.

Accidental death

On some plans an additional sum insured can be taken out to cover death by accident only. This provides for additional cover at lower cost than the ordinary sum insured.

If the life insured dies solely as a result of an accident then the sum insured for accidental death will be paid out in addition to the ordinary sum insured.

Critical illness cover

Some policies cater for critical illness cover as an option on the plan. The plan is normally set up so that if there is a claim the policy comes to an end. If a claim for critical illness is made and the life insured subsequently dies a claim for death benefit cannot be made.

Adding this option provides a cheaper way of covering the risk for critical illness compared to a stand alone plan. However, the disadvantage is that the policy will only pay out once.

There are a wide range of illnesses covered for critical illness including, cancer, stroke, heart attack, major organ transplant, Alzheimer’s disease and many others. Before a claim can be made the life insured has to survive for a period of time, normally 30 days from diagnosis.

TRUSTS

Setting a life insurance policy up under a Trust can provide additional benefits outside of those provided by the policy.

What are the benefits?

The main benefits are:

- In the event of a claim the proceeds are paid outside the life insured's estate. Therefore the sum insured does not increase the deceased's estate for potential inheritance tax liability.

- The sum insured can normally be passed on to the beneficiary(s) within a few days after a claim has been lodged. The beneficiary(s) do not have to wait until probate or letters of administration have been passed by the court.

- A Trust provides more flexibility and security in ensuring that the proceeds of the plan are paid out in line with the life insured's wishes.

How is it set up?

Standard Trust documents are available from the life insurance company providing the plan. These normally meet the needs of most people wishing to use a trust for their new policy. The Trust deed is usually completed at the same time as the life insurance application but the policy once issued can be placed in Trust at a later date.

The life insured (know as the settlor of the Trust) appoints at least 2 Trustees. These are normally trusted family members. In the event of a claim, they have a legal responsibility to pass on the proceeds to the nominated beneficiary(s).

The life insured then decides who they wish to receive the proceeds of the policy if there is a claim. There is also the opportunity to decide what share each beneficiary is to receive.

When completed and signed, the Trust deed is then lodged with the life insurance company for registration. The deed is then returned to the life insured for safe keeping with the policy document.

What happens if there is a claim?

The life insurance policy, Trust deed and death certificate are then lodged with the life insurance company with the claim document. The proceeds of the policy are then paid, normally by cheque, to the Trustees.

The Trustees must then pass on the proceeds to the nominated beneficiary(s) named in the Trust deed and in the share specified.

Types of Trust

Most life insurance companies offer a range of Trusts to suit different situations. The most common Trust used for ordinary life insurance is a Flexible Power of Appointment Trust but other trusts such as an Absolute Trust and Trusts under the Married Women's Property Act are also common.

This is a complex area and you should seek advice from an Independent Financial Adviser as to the suitability of using a Trust to meet your needs.

TAX IMPLICATIONS

The tax situation with life insurance policies is a complex area and you should seek advice from an Independent Financial Adviser or accountant. Tax law is also subject to change. The information given below is only an outline of the position.

Term life insurance policies

Where these policies are used for personal as opposed to business use the sum insured is paid free of tax. This only applies to those policies which have no investment element. The premiums paid do not attract tax relief except on certain older policies.

If the policy is used for business purposes such as keyperson insurance then there may be a tax charge on the proceeds. If when the policy was set up the Inland Revenue agreed to grant tax relief on the premiums the proceeds could be subject to a charge for corporation tax.

Whole life insurance policies

In most cases these plans have an investment element and in the event of a claim or surrender there could be a tax charge depending on the size of the accumulated investment and individual circumstances. When used for business purposes there could also be a charge to corporation tax.

Some whole of life plans have no investment element and in these cases the proceeds are normally paid free of tax. Premiums on policies for personal use are not subject to tax relief except as stated above.

Endowment policies

If these are set up to run for at least 10 years the proceeds at maturity are paid free of tax. If the plan is surrendered before maturity there is no tax charge provided that the plan has been in force for at least 2/3 of the original term.

As with whole life insurance policies including life insurance investment bonds and life insurance savings plans the tax position will vary depending on the type of plan. Professional advice should be taken to clarify the position.

GLOSSARY OF TERMS

Premium

This is the monthly or annual cost of the policy.

Settlor

The term given to the person gifting assets in to a Trust he/she is setting up.

Lapse

This is the term used when a life insurance policy comes to an end due to non payment of the premium. The policy is said to have “lapsed”.

Deferred period

This is the period of time that has to pass before a claim for a benefit can be made. For example, the period of time before a claim for “waiver of premium” or premium protection benefit can be claimed.

Inheritance tax

This is the tax charged on the value of the estate of a deceased person. It is sometimes known as a wealth tax and is charged only on estates over a certain value.

Donor

A person making a gift to another or in to a Trust.

Beneficiary

A person named in a Trust who is entitled to all or a share of the benefits of the Trust.

Close company

A private limited company with 5 directors or less.

Death in service

The term used where an employee dies while working or still in service with the employer. The term is used in connection with a life insurance benefit set up by the employer for the benefit of an employee.

Family Income Benefit

This is a special type of term life insurance plan that provides a regular monthly income in the event of a claim rather than a lump sum. The income is paid for the period of time left on the plan and will then cease with the plan coming to an end without value.