TAXFACTS *Ethics*

Introduction to Life Settlements and Ethical Guidance for Advisors*

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Introduction

An active and rapidly growing secondary market for life insurance emerged less than 10 years ago, and already represents both a challenge to conventional industry practices and wisdom as well as an introduction to a new dimension to estate and financial planning. Not only does this secondary market enhance the asset management options available to advisors and their senior clients, but it redefines the liquidity and asset value characteristics of the life insurance asset class for this demographic group of policy owners. The existence of life settlements, as this secondary market is called, will require advisors to become knowledgeable and proactive on behalf of their clients.

Life insurance is customarily purchased for planning needs that may span a time horizon as few as five or as many as 50 years. Yet circumstances change; hence, life settlements should be viewed as a sophisticated transactional component of a life insurance management and periodic restructure process that requires credible product suitability evaluation, objective analysis, full disclosure, and client affirmation.

Note that this article will address in-force policies that insure seniors but are no longer affordable, suitable, or wanted. It will not address new policies sold to seniors in questionable marketing schemes – so-called stranger-owned life insurance – that include policy sales after the contestable period. For the purpose of this article, such schemes are not considered part of the legitimate secondary market for life insurance.

Life Settlement Basics

Definition of a Life Settlement

A life settlement is the sale to a third-party purchaser of an in-force life insurance policy for its "fair market value": an amount in excess of the contract's cash surrender value but less than its death benefit. The policy owner/seller is not restricted in the use of the proceeds. The settlement company acquires policy ownership, names itself the beneficiary, and is solely responsible for future premium payments.

Life Settlements Versus Viatical Settlements

A viatical settlement is the sale of an in force life insurance policy insuring a person who is terminally *or* chronically ill. The Internal Revenue Code deems a person *terminally* ill if he or she is certified by a physician as having an illness or physical condition that can be reasonably expected to result in death within 24 months of the date of physician certification. A *chronically* ill person is defined as any person, other than a terminally ill person, certified within the preceding 12-month period by a licensed health care practitioner as having limitations similar to those qualifying for long-term care. A qualifying viatical should result in a cash offer between 50% and 80% of the policy death benefit and will receive the same income tax free treatment as if the insured died and was entitled to treatment under the provisions of Section 101(a).

A life settlement, on the other hand, is generally pursued for economic policy restructure reasons. The cash offer will be a lower percentage of policy death benefit based on insured life expectancy that can range from 25 to 144 months. Whereas viatical regulations are reasonably addressed by the various state insurance departments and their taxation by Internal Revenue Code, life settlements currently have fewer regulations *and* their tax treatment is less clear.

Life Settlement Versus Living Benefits Rider

A living benefits rider is a provision added to a life insurance policy providing a benefit similar in concept to a viatical settlement. The qualification for benefits is the same as for a viatical, but policy ownership is not transferred to the life insurance company. The total death benefit is paid to the policy owner and beneficiary in two forms: a portion (typically not more than 50%) is paid to the policy owner during the insured's lifetime with the balance (if the policy is still in force) paid to the beneficiary at the insured's death.

Parties to a Life Settlement

Party titles and industry terminology are confusing and can vary from state to state. While life settlements are different from viatical settlements, some states include life settlements as part of their viatical settlement legislation. Regardless, advisors are expected to understand the parties and their functional role for the state in which they are transacting a life settlement.

- *Policy Owner* is the person/entity who has the right to sell the policy.
- *Insured* is the person covered under the policy. The insured may or may not be the policy owner. If the policy owner is not the insured, the policy can be sold to the life settlement purchaser *only* with the insured's written consent.
- *Broker* is the person/entity who represents the policy owner and is licensed to do so, if state licensing for viatical/life settlement sales is required. The broker owes a fiduciary duty to the policy seller to act according to the seller's instructions and in the best interest of the seller.
- *Provider* is the person/entity that effectuates a life settlement contract and manages the transaction on behalf of a third-party purchaser. Among other duties, the provider obtains life expectancy calculations from approved life settlement consulting actuaries, performs policy examination, and determines the "fair market value" offer amount.
- *Purchaser/Funder* is the person/entity who gives a sum of money in consideration of a policy and is entitled to a beneficial interest in a trust that owns one or more policies. In some instances, a purchaser/funder may also be a provider.
- *Independent Escrow Agent* is an entity designated by the provider and recognized by governing state authority (i.e. Insurance Commissioner) to accept, transmit, and pay the proceeds of a life settlement.

Policies qualifying For a Life Settlement

Most life insurance policy types qualify for a life settlement, including universal life, adjustable life, whole life, survivorship, joint first to die, and even individual term and group term insurance, if convertible (and assignable). Variable policies also qualify but some providers will not consider them. Policies can be owned by individuals, corporations, partnerships, trusts, and charities.

Typical Life Settlement Eligibility Requirements

Life settlements have several eligibility requirements. The insured's life expectancy must be between 25 and 144 months, based upon one or more life expectancy calculations. The insured should be at least age 65 unless health impairment has shortened the insured's life expectancy. Other general policy requirements include:

- A minimum policy face amount of $250,000.
- The policy must be beyond the 2-year contestable period, subject only to payment of premiums.
- The policy must not be subject to restrictions (e.g. a split dollar arrangement) that would prevent payment of a death benefit to the settlement company at the insured's death.
- The underwriting carrier must verify that the policy is in force and not encumbered by any other party.
- The underwriting carrier must have a BBB or more favorable third-party rating.

Factors Determining How Much The Settlement Company May Pay The Seller

The amount paid to the seller depends on the insured's estimated life expectancy, ongoing policy expenses (primarily the premium or the cost of insurance), current policy benefits (primarily the death benefit, but accumulation and cash surrender values are also considered), and the purchaser's processing costs, cost of capital, and internal rate of return objective.

Typical Reasons To Consider Selling An Existing Life Insurance Policy

The owner of a life insurance policy can either sell all or part of a policy as a life settlement. Some reasons to consider a sale are:

- The policy is no longer needed by the owner and a sale for the "fair market value" will generate proceeds in excess of the policy cash surrender value.
- A policy lapse notice has been received and/or premium payments are no longer affordable, and a sale for the "fair market value" will generate proceeds that wouldn't otherwise be available from a lapsing policy.
- The policy is no longer suitable or affordable or is significantly under-performing the original policy expectation,[1] and analysis indicates it should be exchanged for a more efficient product.
- The life settlement sale will generate a higher amount of cash than policy exchange/surrender that could be placed into a new policy, thus reducing the ongoing premium commitment or increasing the death benefit.

Life Settlement Transaction Examples

The following transactions illustrate the liquidity and asset value benefits of life settlements.

1. A $4,000,000 corporate-owned policy with a $500,000 cash surrender value insured an age 89 male for key man coverage purposes. The business had not made scheduled premium payments for several years because the next management generation was in place and had undertaken an aggressive capital expansion program. The policy was within 18 months of lapse, the insured was in good health for his age, and annual premium payments in excess of $200,000 would be required to sustain coverage. The policy was sold for $850,000, representing 21% of the death benefit and $350,000 more than the cash surrender value. The proceeds were used to internally fund the capital expansion program.

2. A $5,000,000 trust-owned policy with a $2,500 cash surrender value insured an age 82 female. Following receipt of the lapse notice, the corporate trustee learned that the policy, purchased over 15 years ago, was no longer needed. The policy was sold for $900,000, representing 18% of the death benefit and $897,500 more than the cash surrender value. The sale proceeds were reinvested in fixed income and equity investments.

3. A $1,000,000 *term* insurance policy with *no* cash surrender value insured an age 72 male. The YRT renewal premiums were not affordable, and the policy was no longer needed. It was sold for $110,500, representing 11% of the death benefit, *plus an unexpected $110,500 cash payment*.

Tax Implications of Life Settlements

At the time of this writing, there are no Internal Revenue Code provisions or IRS rulings pertaining specifically to the income taxation of life settlements. Many authorities use the following assumptions in calculating the projected tax liability:

- If the seller's policy cost basis (the total amount of net premiums paid) is higher than the Life Settlement amount, the seller will not realize any taxable income from the transaction.

- If the life settlement amount is higher than the seller’s cost basis, the excess of the policy's cash surrender value at the sale date over the seller's basis is taxable gain. It is unsettled whether the gain is treated as ordinary income and taxed at the seller’s marginal tax rate or is treated as capital gain.[2]

- If the policy has no cash surrender value, or the surrender value is less than the policy’s cost basis at the date of policy sale to the provider, then consistent with the assumption posed above, the excess of the settlement amount over the seller's cost basis could be treated as a taxable gain (ordinary income or capital gain, depending on the position the IRS takes).

This projected tax liability should be calculated by the seller’s tax advisor as part of the initial life insurance versus life settlement “trade-off” evaluation, and certainly taken into account before accepting a life settlement offer. Also, it should be pointed out that the tax consequences to the policy owner/seller receiving a cash payment during the insured's lifetime are not as favorable (or certain) as that of receiving the policy's death benefit.

Ethical Guidance

In considering a life settlement, a life insurance agent, attorney, accountant, or trust officer is expected to solely represent the best interests of the policy seller, regardless of the manner in which the advisor is compensated Also, an advisory team is an appropriate collaborative tool that can better assure objectivity, client focus, and informed, fully disclosed decisions.

Advisor’s Duty To Discuss The Life Settlement Option

A 2005 study of professionals by Maple Life Financial, a Maryland-based life settlement provider, found that 45% of survey participants had clients over age 65 who surrendered a life insurance policy for its cash value. Many of these individuals could have qualified for a life settlement and obtained a cash payment significantly in excess of the policy's cash surrender value. For example, cash surrender values average just 4%[3] of policy face amounts while life settlements average 25-30%.[4]

Advisors who are *not* licensed life insurance agents should identify life insurance policies and client situations that are potentially appropriate for life settlement consideration. Such advisors cannot assume a life insurance agent or carrier is informing the policy owner about the life settlement option. A recent market research study[5] indicated that 52% of surveyed agents never speak to clients about life settlements, 60% do not know enough about life settlements to anticipate a life settlement transaction within the next 12 months, and 75% are not familiar with their state regulations concerning life settlements. Unfortunately, many agents and registered representatives are restricted from discussing life settlements with policyholder clients.

"Orphan" policies also present a dilemma. These policies, most commonly owned by seniors, are no longer serviced by an insurance agent. This usually occurs when the policy-selling life insurance agent retires/terminates and the policy service function is not assigned to another agent. As a result, the policy owner receives the carrier's periodic premium billing notices without the benefit of ongoing policy service. These neglected, often older policies receive no risk management attention and are fraught with danger such as lapse or are in an unsuitable status.

Issues And Concerns Advisors And Professionals Must Consider With Respect To Life Settlements

A client must truly understand the rights – and obligations – forfeited in exchange for a lump-sum sale of the policy. Product suitability and full disclosure are market conduct concerns at the financial services, life insurance, and life settlement industry levels. Well-publicized investigations and lawsuit settlements demonstrate the need for third-party intervention to address transparency issues at all levels. It is imperative that the policy seller have the guidance of a trusted advisor who will engage, if appropriate, an independent consultant to assist in a credible and fully disclosed transaction process.

In addition, advisors should demand full disclosure of life insurance "soft dollar" commission and life settlement fee compensation, the use of sales and in-force illustrations, premium adequacy determinations, policy spreadsheet comparisons, and the life settlement "bidding process." Full disclosure must avoid factual omissions of "knowable" information.

Conclusion

A life insurance policy is personal property and can, therefore, be sold by its owner. The secondary market is established and demonstrates the enhanced liquidity and asset value available to seniors for about-to-lapse, unwanted, or unsuitable life insurance policies. Failure to disclose the life settlement option creates a problematic transparency issue. Advisors should integrate this option into their respective practice management and standard of care procedures.

Financial professionals in their various disciplines play a key advisory role in the management and restructure of policies held by their senior clients. The age 70 to 90 population relies on their advisors to identify changed circumstances, such as life insurance policies that may now warrant life settlement consideration. Resolution of questionable life settlement and life insurance marketing and transparency practices should not impede advisors from fulfilling their client management duties.

In general, life settlement creates a *paradigm shift* in estate and financial planning for seniors that requires life insurance to be actively managed no differently from fixed income, equity, and real estate asset classes. The secondary market continues to experience dramatic growth because it (1) addresses a basic consumer demand similar to the secondary market for securities and real estate, and (2) attracts established and credible institutional funding sources. These sources are imposing a "corporate governance" discipline on the transaction process intended to minimize questionable practices that inevitably occur in any emerging marketplace.

[1] "When is a Premium Not a Premium," *Journal of Financial Service Professionals*, July 2005, Richard M. Weber.
[2] "Cash Out or Cash In?" *Trusts & Estates*, May 2005, Charles L. Ratner.
[3] "Turn Unneeded Policies Into Cash: A Life Settlement Can Be A Better Alternative Than Surrendering A Policy," *Journal of Accountancy*, September 2005, James D. Warring.
[4] "Life Settlements – The Concept Catches On," Conning Research & Consulting, Inc., 2006.
[5] 2005 Life Settlement Study, Agent's Sales Journal, Agent Media.

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