Steve Leimberg's Estate Planning Newsletter #2401 – March 24, 2016

# A Professional Adviser's Guide to Life Settlements

By Michael D. Weinberg, JD, AEP®

*"A sale of a life insurance policy in a life settlement can be very advantageous where a policy owner no longer needs or wants the policy or is unwilling or unable to pay future premiums. However, a life settlement should only be undertaken after the pros and cons of selling the policy have been thoroughly analyzed and considered. Assuming suitability, a sale of a policy will frequently result in more money for the policy owner than surrendering it and certainly more money than letting the policy lapse. It is an alternative that should be considered by every policy owner where the insured is an older person and meets the parameters for a life settlement."*

We close the week with **Mike Weinberg**'s "Professional Adviser's Guide" to life settlements.

**Michael D. Weinberg, JD, AEP®**, is the President of **The Weinberg Group**, Inc. in Denver, CO. Mike works with individuals, families and businesses and their professional advisers to design and fund business succession and estate plans, and to place in the life settlement market existing life insurance policies that are no longer necessary or desirable. He also serves as a consultant and expert witness in life insurance and life settlement matters. Mike has 50 years of experience and previously served as a tax attorney in the Office of Chief Counsel, Internal Revenue Service, New York City. He is both a former co-chair of the Insurance Committee of the Real Property, Probate and Trust Law Section of the American Bar Association and the editor emeritus of *The Insurance Counselor* primer series. He is certified as an Accredited Estate Planner (AEP®) by the National Association of Estate Planning Councils and is a consultant to the Planned Giving Office of Stanford University. Mike has lectured for the American Bar Association, American Law Institute, Heckerling Miami Estate Planning Institute, Notre Dame Estate Planning Institute, Practicing Law Institute, Southern California Tax & Estate Planning Forum, Texas Bar Association Advanced Estate Planning Course, Association for Advanced Life Underwriting, Forum, Million Dollar Roundtable, Society of Financial Service Professionals, Top of the Table, and numerous estate planning

councils. He has published articles as author or co-author in the *Estate Planning Journal, Insights & Strategies*, *Journal of Asset Protection*, *Journal of Financial Service Professionals*, *Journal of Taxation*, *Probate & Property*, and *Trusts and Estates,* and is the co-author with Larry Brody of *The Insured Stock Purchase Agreement (1st edition),* published by the ABA. He is also the co-developer with Steve Leimberg of "Life Settlement NumberCruncher™," a software program designed to help clients and their advisers determine the economic viability of retaining a policy or selling it in a life settlement. Mike Weinberg can be reached at the following address: mweinberg@theweinberggroup.com. Website: www.theweinberggroup.com. He welcomes your questions.

*Acknowledgements*: Many thanks to **Mark Armstrong**, MA, Vice President of Life Insurance Marketing, and **Pam Bancsi**, JD, CFP, Director of Insurance Services, of **ValMark Securities, Inc.**, my life settlement broker, and **Ben Weinberg**, JD, MBA, MCSE, Senior Vice President of **The Weinberg Group**, for reviewing this commentary and providing their perceptive insights and helpful comments.

Before we get to Mike's commentary, members should note that a new **60 Second Planner** by **Andy DeMaio** was recently posted to the **LISI** homepage. In his commentary, Andy reports on Notice 2016-27, where the IRS has once again extended the initial due date for filing Form 8971. The Notice can be found at http://src.bna.com/dxZ, and members can click this link to listen to the podcast.

Now, here is Mike Weinberg's commentary:

## EXECUTIVE SUMMARY:

With a life settlement, a policy owner sells a life insurance policy to a third-party institutional investor where the policy owner no longer needs or wants the policy or is unable or unwilling to pay future premiums. Like most major financial transactions, it should only be considered after a thorough analysis of the pros and cons of retaining the policy vs. selling or surrendering it. A life settlement will necessarily result in the policy owner receiving a greater amount than if the policy were allowed to lapse and frequently more than if the policy were surrendered for its cash surrender

value. The focus here will be on policy sales rather than surrenders. Where appropriate, surrenders will be discussed as well.

This commentary is a ten point guide for the professional adviser about life settlements. It covers: 1. Definitions; 2. Pros and cons; 3. Life settlement parameters; 4. Determining policy fair market value; 5. Process; 6. Income taxation of surrenders and sales; 7. Regulation; 8. Insurance carrier attitudes; 9. Missed opportunities; and 10. Selecting a life settlement agent and broker. The sale of a policy should be considered as an option in every case where the insured is an older person and meets the parameters for a life settlement.

## COMMENT:

### 1. Definition of a Life Settlement

A life settlement is the sale of an existing life insurance policy on the "secondary" market to a third-party institutional investor (such as a hedge fund, pension fund, or bank) for more than the policy's cash surrender value and less than its death benefit. In a life settlement transaction, the policy owner sells the policy in exchange for a lump sum cash payment. Note that a policy owner may be the insured or an entity, such as an irrevocable life insurance trust or a business.

The institutional investor becomes the owner of the policy, makes future premium payments, and receives the death benefit at the insured's death. A note concerning terminology: Unless the context indicates otherwise, the terms "policy owner" and "seller" are used interchangeably to describe the seller of a policy, and the terms "buyer," "institutional investor," and "life settlement provider" (who represents the buyer) to describe the buyer of a policy.

With institutional investors, policies are owned in large blind pools with many other policies. This can help to assure client confidentiality. A "blind pool" is a term of art and is often used to describe policies that are purchased as large blocks or as a portfolio of policies. An investor participates in the performance of the policies similar to a bond portfolio where the investor is less concerned about each individual bond and more concerned about the overall performance of the pool of assets. Institutional investors do not have access to an insured's personal information for policies in a pool because

they do not have identifying information for any particular insured. However, the company that services these portfolios will know the names and contact information needed to track an insured's health and medical status.

It may be possible to sell a policy to an individual investor. That is rare, and it is not recommended because this individual investor will necessarily have a one-on-one relationship with the insured and policy owner, and confidentiality will be lost. In my opinion, for obvious reasons, an insured should never consent to the sale of a policy to another individual who has no insurable interest in the insured and who stands to profit from the insured's death.

Note that a life settlement differs from a viatical settlement. Viatical settlements arose during the AIDs epidemic. In a true viatical settlement, the insured is terminally ill and has a life expectancy of 24 months or less. True viaticals are strictly regulated, and they receive favorable tax treatment (see IRC sec. 101(g)). Viatical and life settlements are frequently confused; for example, a state's viatical settlement regulations may include life settlements without separate designation.

## 2. <u>The Pros and Cons of a Life Settlement</u>

*"Pros"*

The "Pros" of a life settlement are fairly easily stated. For an insured or other policy owner who no longer needs or wants a policy (e.g., estate within estate tax exemptions), who no longer wishes to pay premiums (e.g., can no longer afford them), or whose circumstances have changed (e.g., a divorce or sale of a business interest), a life settlement may be in order, provided the insured meets the parameters for a life settlement. (See "3" below, "Parameters of a Good Life Settlement.") A life settlement will obviously produce a greater amount for the policy owner than allowing the policy to lapse, and will frequently result in a greater amount than surrendering the policy for its cash surrender value.

In considering the Pros of a life settlement, a client will be in good company if the client decides to undertake the life settlement (assuming it's suitable – see "Cons" below). The industry organization, the Life Settlements

Insurance Association (LISA), cites some interesting statistics on its website, www.lisa.org.

- A recent study from Conning, Inc., a leading investment management company for the global insurance industry, found that investors purchased $1.7 billion worth of U.S. life insurance face value in 2014, bringing the total active life settlements market to more than $32 billion, http://www.lifehealthpro.com/2016/01/22/investors-analysts-agree-life-settlements-asset-c?t=life-settlements&page_all=1&slreturn=1454423006.

- According to Conning, Inc., the annual volume of life settlement transactions will average approximately $3 billion per year in face value over the next decade. This is an established and growing industry, http://www.lisa.org/consumer-advisors/advisors-frequently-asked-questions ("How substantial is this industry?").

- According to a 2010 U.S. Government Accountability Office (U.S. GAO) study, U.S. policy owners received $5.62 billion more than policy cash surrender values from life settlements from 2006-2009, http://www.lisa.org/consumer-advisors/advisors-frequently-asked-questions ("How substantial is this industry?"), which was 4-8 times more than the cash surrender values during that period, http://www.lisa.org/life-policy-owners/frequently-asked-questions ("How much can I get?").

- Americans who sold their unwanted life insurance policies collectively received more than four times the amount they would have received had they surrendered these policies to their issuing life insurance companies. London Business School Study, 2014, http://www.lisa.org/life-policy-owners/frequently-asked-questions ("How much can I get?").

The LISA website is a helpful resource about life settlements. Other useful research and reference sources are the Insurance Studies Institute (ISI) website, www.insurancestudies.org, and explanatory materials published by reputable life settlement firms, like **ValMark Securities, Inc.**, the life settlement broker with whom I'm associated. Two other excellent reference sources are "Tools and Techniques of Life Settlement Planning" (co-

authored by **Steve Leimberg**, **Caleb Callahan**, **Brian Casey**, **James Magner**, **Barry Reed**, **Larry Rybka** and **Paul Siegert** and published by the National Underwriter Company), and **S. Leimberg, M. Weinberg, B. Weinberg**, and **C. Callahan**, "Life Settlements – How to Know When To Hold and When to Fold," Estate Planning Magazine, Pg. 3, Aug. 2008, Vol 35/No. 8.

*"Cons"*

The "Cons" of a life settlement essentially consist of the factors to be considered in determining whether to retain or sell a policy. In short, is a life settlement suitable for the policy owner? A life insurance policy is a valuable asset, and a policy owner needs to carefully consider these factors in conjunction with his or her professional advisers before deciding to sell a policy. Here are the important factors that should be considered before pursuing a life settlement.

- The existing policy may be flexible enough to allow changes (such as a death benefit reduction) that eliminate the need to pay further premiums while maintaining the coverage for all years.

- There may be alternatives to a life settlement, such as a "1035 exchange" to a new less expensive policy, a policy loan to preserve the existing policy, or an accelerated death benefit option.

- The proceeds from the sale of a policy may be subject to state or federal taxes, subject to the claims of creditors, and adversely affect eligibility for Medicaid or other governmental programs.

- An existing policy that has been sold will reduce the overall insurance industry capacity to offer future coverage on the particular insured. As a result, the opportunity to purchase additional insurance on this insured's life in the future may be diminished or no longer available.

- All medical, financial and personal information obtained during a life settlement may be disclosed to other parties, some of whom are unknown. The insured may be required to renew permission to share this information. The buyer's representative will periodically contact the insured or the insured's designee (such as a child) to evaluate his

or her health. (For more about confidentiality considerations, see "1" above, "Definition of a Life Settlement.")

- By entering into the life settlement contract, the policy owner and the beneficiaries of the policy will be transferring all rights they may have under the policy to the buyer. Additionally, the life settlement transaction may cause the forfeiture of certain rights and benefits that exist under the policy, such as conversion rights and waiver of premium benefits.

- The client should be aware that a life settlement transaction can take much longer than a typical securities transaction, typically 3-6 months. As such, the client should weigh the benefits of selling a policy against all other factors. Transaction costs for the life settlement should also be considered when evaluating the sale of the policy, especially agent and broker compensation which should be fully disclosed (see "10" below, "Selecting a Life Settlement Agent and Broker.")

- Before selling a life insurance policy, an evaluation of the client's current income needs versus those of the insured's beneficiaries should be conducted, and these beneficiaries should approve the life settlement transaction in addition to the client and the client's advisers before proceeding.

- If an existing policy is to be retained, or a new policy purchased to replace the existing policy, the issuing insurance company's financial strength should be assessed.

- Last but not least, the human factor needs to be considered. Is the insured comfortable with someone else owning a policy on his or her life, albeit an institutional investor? Usually, this will not be an issue once the life settlement transaction is thoroughly analyzed and explained (of course, assuming suitability in the first place). As indicated in the statistics quoted above, life settlement sales of billions of dollars in face amount are transacted yearly so the insured joins a large group of persons selling their policies, and life settlements are regulated in most states to protect insureds and policy owners (see "7" below, "Regulation of Life Settlements.")

Once these factors are thoroughly explored, then a financial analysis should be made of various methods and costs of retaining the policy (assuming the client has an interest in retaining the policy as an option).

Next, assuming a life settlement is to be pursued, the *net after-tax proceeds* from a surrender of the policy vs. a life settlement should be determined. In making this analysis, for a policy surrender, any income taxes imposed need to be subtracted from the gross surrender proceeds in determining the net after-tax surrender proceeds. For a life settlement, it's crucial that both income taxes *and* agent and broker compensation be subtracted from the gross offer in determining the net after-tax sales proceeds, rather than looking at just the gross offer which would be highly misleading. The income tax aspects of a policy surrender or sale are discussed below (see "6" "Taxation of Policy Surrenders and Sales").

## 3. Parameters of a Good Life Settlement

*Potential Candidates for a Life Settlement*

- Insureds who are age 70 and older (75 years or older if female).
- Insureds who have a projected life expectancy of 10 years or less. The shorter the insured's life expectancy, the better insofar as the buyer is concerned.
- Insureds who have had a decline in health from original policy issue.
- Life insurance policies that have a net death benefit of $250,000 or more (no maximum).
- The policy type can be Universal Life, Guaranteed Universal Life, Survivorship Universal Life, Variable Universal Life and Convertible Term (sometimes Whole Life). Flexible premium policies like universal life are more favored by buyers because they can readily adjust the premiums going forward.
- The policy owner (the seller) can be the insured, a trust, or a business entity.
- The annual premium should be 5% of the death benefit (or less), and the cash surrender value should be 15% of the death benefit (or less).

*Potential Life Settlement Scenarios*

- The insurance is no longer needed or wanted and the policy owner would like to terminate the policy and receive a lump sum cash payment, frequently in excess of the policy's cash surrender value were it to be surrendered.

- The policy owner no longer wants to pay further premiums to keep the policy in force or simply can no longer afford to continue paying the premiums.

- Estate tax issues have changed making the life insurance unnecessary for tax payment purposes (e.g., the insured's estate will fall within estate tax exemptions). (Be sure to check both Federal and State death taxes).

- The long term performance of the existing policy is uncertain, and the policy owner would not like to gamble on the outcome. (In this way, oddly, a life settlement becomes a "risk management" tool.)

- The existing policy is underperforming and the policy owner would like to obtain a new guaranteed policy instead of the existing one (a possible alternative to a 1035 exchange).

- The policy owner would like to obtain a new variable policy that provides equity exposure instead of the existing policy (another possible alternative to a 1035 exchange).

- A convertible term policy is nearing the end of its specified term period (e.g., 10 years). The policy owner can convert to a permanent policy, and through a life settlement, realize cash proceeds for an otherwise worthless asset. (It may come as a surprise to many policy owners and their advisers that a convertible term policy can be a good candidate for a life settlement.)

- A business is sold or changes are made that make the insurance no longer needed.

- Changes occur within a buy-sell agreement that make the insurance no longer needed (e.g., a shareholder or partner leaves the business).

- An executive retires and receives unneeded insurance through a deferred compensation arrangement.

- Existing policies do not (or no longer) meet the objectives of an irrevocable life insurance trust.

- Charity-owned policies are underperforming and need to be terminated or replaced in order to accomplish the goals of the charity.

- Funds are required immediately for personal needs, such as retirement, long-term care, or family emergencies.

- Family situations occur that require changes in insurance (e.g., divorce).

## 4. Factors that Determine a Policy's Market Value

*From the Buyer's Point of View*

When a policy fits the parameters for a good life settlement (see "3" above), how is its market value determined? There are four critical interrelated factors a buyer will consider to determine the pricing of a policy:

- Policy death benefit;
- Insured's projected life expectancy;
- Future premiums (usually based on Costs of Insurance, "COIs); and
- Buyer's target interest/discount rate.

The policy death benefit and the buyer's expected interest/discount rate are known values. The unknown factors that affect the valuation are the life expectancy of the insured and the future premiums that will have to be paid over the insured's life expectancy until her or his death. In determining the insured's life expectancy, there are independent firms (called "life expectancy firms") that will provide projected life expectancies for a fee based on personal information from the insured and medical information from the insured's physicians. No physical exam of the insured is required.

Interestingly, projected life expectancies from these life expectancy firms can vary widely based on identical information. So, it's caveat emptor for the buyer who will usually choose the shorter, more conservative life expectancy projections. For more on life expectancy analysis, see **Steve Leimberg**, "Life Expectancy Analysis – Estate Planning Tool of the Future-Available Now," Estate Planning Magazine, Pg. 3, Sept 2008, Vol. 35/No 9. In general terms, a life settlement offer is determined by a mathematical calculation equal to the net present value (NPV) of the policy's death benefit, minus the net present value of future premiums, based on the insured's projected life expectancy. This amount is reduced by the buyer's expenses in arriving at the amount of the gross offer made to the seller. (These calculations are actually more complicated, and I've simplified them for ease of understanding.) From the gross offer, agent/broker commissions, and policy loans, if any, are subtracted in determining the net offer to the seller. The net present values are calculated at a discount rate equal to the return on investment that the investor seeks to obtain. In today's market investors are currently looking to obtain a 15-17% Internal Rate of Return (IRR) on investment. (IRR is defined as the average annual return earned through the life of an investment.)

While the policy death benefit remains fixed, the cost of maintaining the policy (i.e., the future premiums) until the insured's death obviously plays a large role in the valuation of a policy. So, the accuracy of the insured's life expectancy projection is crucial to the buyer in calculating the amount to offer the seller. A good measure of judgment by the buyer and its needs at the particular time will enter into determining this amount (e.g., does the buyer want to hedge its investments by buying policies with shorter or longer life expectancies to balance its portfolio of policies?).

*From the Seller's Point of View*

A seller may say that all of this information concerning the buyer's point of view is interesting, but I'm more interested in knowing that I'll get the highest net price for my policy regardless of how the buyers arrive at their offers. The actual process for assessing buyers' offers is by an auction where the buyers through their life settlement providers bid for the policy. Usually, the highest bid gets the policy so the seller will get the highest offer through the auction process (see "5" below, "The Life Settlement Process").

Obtaining the best price for a policy is both art and science, and good life settlement agents and brokers need to be very strong at both. It is not just going through a mechanical auction process. A good life settlement agent and broker will know how to navigate the bidding process by properly packaging the policy and managing the documentation. I had a case where only one bid was made for the policy, $1.6 million for a large policy. Through both art and science, my life settlement broker - ValMark Securities - went back to the buyer and negotiated a higher price of $2 million, a 25% increase. (Individual negotiation may not be available if the policy is in auction with multiple bidders.)

A good question is what is the current state of the market, and is it a good time to sell a policy? In a nutshell, the current market is excellent, and it is a good time to sell a policy (as of the date this was written in March 2016). I had another recent case where the gross offer was over 50% of the *face amount* of the policy. (The net sales price, after agent/broker commissions, income taxes, and policy loans, was three times the policy's net cash surrender value.) I've never encountered an offer this high. Of course, each case is fact specific although the facts of this particular case didn't strike me as all that unusual.

Why is the life settlement market so attractive right now? First, and foremost, is the current very low interest rate environment. There is a lot of money flowing into this market from institutional investors to buy policies as they seek higher returns than they can get from traditional fixed income investments. One life settlement provider announced last year that it had secured $250 million from investors for policy purchases. Second, there is currently a great demand for policies and therefore more competition among buyers, resulting in what could be called a "seller's market." Third, buyers can borrow money at low interest rates to purchase policies and make future premium payments. Fourth, life insurance policy values are a good non-correlating asset, meaning they don't fluctuate with the ups and downs of the market. The principal risk for investors is not stock market volatility or safety of their investment. It is that the insured will live too long beyond life expectancy and make the policy purchase uneconomic (see the discussion above "From the Buyer's Perspective").

## 5. The Life Settlement Process

As mentioned earlier, The Insurance Studies Institute (ISI) has published a number of interesting and useful studies about life settlements, www.insurancestudies.org. An outstanding ISI publication is "Should I Sell My Life Insurance Policy? A Consumer's Guide to Life Settlements." This publication contains an excellent section describing the life settlement process in detail. With the kind permission of ISI, the section is reprinted here in its entirety, http://insurancestudies.org/wp-content/uploads/2010/05/ISI_2009_Consumers_Guide_to_LS_full1.pdf ("The Life Settlement Process").

*"The Life Settlement Process: What Can I Expect?*

The process of selling your life insurance policy requires numerous documents and extensive information verification. It can require 3-6 months. Also be aware that in states where life settlement laws exist, agent, broker, and provider firms are typically required to be licensed to do business in such states. This is for your client's protection (see "7" below, "Regulation of Life Settlements").

*Important players*

- Policy Owner: The person who contracts with an insurance company for a life insurance policy.
- Agent: Helps determine if a life insurance policy should be sold and assists the policy owner in completing a life settlement (represents the seller).
- Broker: Person or entity with whom the agent is affiliated and who negotiates the sale of a life insurance policy between a policy owner and a buyer/investor (represents the seller).
- Provider: Person or entity who manages the acquisition of a life insurance policy for a buyer/investor (represents the buyer).

This section illustrates a typical process. Your actual experience may vary somewhat by the firms with which you do business. Your life settlement agent can help you through the steps. It begins with an application form disclosing your desire to sell your policy. You will also sign a HIPAA form to release your medical records from your health providers.

In limited situations, it may be possible for you to contact and sell directly to a life settlement provider, or to deal directly with an investor (not recommended – see “1” above, “Definition of a Life Settlement”). You may even work through lawyers, CPAs, trustees, financial planners, and other such professional advisors to help you sell your life insurance policy. Whatever process you utilize, be careful not to accidentally circumvent laws and regulations that your state may have put in place for your protection. Know your legal rights and responsibilities.

*The Steps*

- Your life settlement agent submits your application, a copy of your policy, a policy illustration, and your medical information to a life settlement broker with whom the agent is affiliated. The broker then submits this information to life expectancy professionals who evaluate your health and estimate your life expectancy (“life expectancy firms”). The value of your life insurance policy is largely determined by your life expectancy.

- When your life expectancy reports are completed, the broker submits your information to life settlement provider firms who represent the investors “(life settlement providers”). The provider firms determine a value for your policy and submit bids to your broker. The broker solicits as many bids as possible from provider firms and, working with your life settlement agent, provides the best bids to you. Some states require that all bids be disclosed to you.

- You decide which bid, if any, you want to accept. The highest price may not always be the best offer. You should consider the closing time, the experience, professionalism, and reputation of the involved parties, protection of your information, ongoing policy servicing arrangements, and commissions/fees to be paid to all parties. You should evaluate the bid carefully – read its conditions and attempt to determine how much money is being paid in commissions to your agent and broker. Agent and broker commissions are paid from your gross policy value. (See “10” below, “Selecting a Life Settlement Agent and Broker”). Fees paid to the life settlement provider firms are typically paid by the investor, so these should be of less concern to you.

- After you accept a bid, the provider firm will issue you a formal "offer/acceptance" agreement for your life settlement broker to sign on your behalf. This offer/acceptance agreement will typically contain several conditions, including:

    - verification of your policy and its ownership by the insurer;
    - discovery and verification of ownership documents if the policy is owned by a trust or other entity;
    - verification of the life expectancy report(s) and of the information in your application; and
    - a check for evidence of fraud in all information related to your insurance policy.

- When all verifications are completed, the provider firm prepares a package of closing documents for you to sign. Such packages may contain 20-30 forms, similar to a house purchase or mortgage closing. Your life settlement agent (or if you prefer, your attorney or other advisor) will help you understand and execute these documents.

- Within several days of receiving your signed closing documents (some states specify the number of days), the provider arranges for the money to be paid to you to be deposited with an independent escrow agent. The money is held in escrow until all documents are reviewed, deficiencies (if any) are corrected, and the insurance carrier transfers ownership of your policy to the investor. One to three days thereafter, the money is paid to you.

- After the money has been paid to you, in a regulated state, you will typically have a period of 15-30 days to rescind the transaction for any reason. In a non-regulated state, you may or may not have a rescission period, depending on the terms of your closing agreement. This rescission period gives you time to reflect on what you did and enables you to rescind the transaction if you think it was the wrong thing to do. If you rescind, you must return all money prior to having the ownership of the policy revert to what it was prior to the transaction. If your death occurs during the rescission period, the sale is also rescinded, and the full policy

death benefit is payable to your beneficiaries (less the amount previously paid you).

- From thereon until your death, the new policy owner will periodically contact you or your named representative to verify your address and health status. Most states prohibit such contacts to be more frequent than once per quarter until the 12 months preceding your life expectancy at which time they may contact you monthly. Depending on the closing agreements, the new policy owner may have the right to require you to produce updated medical records or to submit to a physical examination; if this happens, it should be infrequent. (Generally, the new owner will only require you to cooperate by signing a HIPAA release in order to be able to obtain updated records.) Upon your death, your estate executor or heirs will be obligated to provide a copy of your death certificate to the new policy owner to file with the insurance carrier for the policy death benefits."

There are several other less traveled routes to a life settlement that do not use the normal auction process for determining the price for a policy. First, a provider may offer to purchase a policy directly from a policy owner for a privately negotiated (non-auction) price. Except in the case of smaller policies that are not viable in the auction market, this approach is not appealing because it will likely not produce the best offer for the seller.

A second route is what's called the "no life expectancy" (No-LE) life settlement. This route is for healthy senior insureds whose life expectancies are too long to be acceptable to the auction market. The no-LE route is rare; nevertheless, this approach may work in the right circumstances. Please refer to a recent article in the Feb. 2016 "California Broker" magazine for further details,
https://issuu.com/californiabrokermagazine/docs/california_broker_february3_2016/36?e=16574335/33325580.

## 6. Income Taxation of Life Settlements and Policy Surrenders

The proceeds of a policy sale or surrender received by a policy owner are subject to income taxation. Computation of these taxes has become complicated because of Revenue Ruling 2009-13. (A companion ruling, Rev. Rul. 2009-14, deals with income taxation of the buyer of a policy which will

not be discussed here.) Much has been written about this ruling, which has been covered in the following **LISI** Estate Planning Newsletters: #1457, #1459, and #1462. Rather than discuss these analyses and critiques in any detail, let's examine the taxation of surrenders and sales under Rev. Rul. 2009-13 through the facts and conclusions of the ruling itself.

*a. Facts*

- Cash Surrender Value (CSV) = $78,000
- Premiums Paid = $64,000
- Costs of Insurance (COIs) $10,000 (calculation unexplained – see "e" below)
- Sales Price = $80,000
- Policy Holding Period = 8 years

*b. Surrender*

- "Investment in the Contract" = $64,000 premiums paid (less any amounts previously received that were excludible from income - none here)
- $78,000 CSV - $64,000 investment in the contract = $14,000 gain
- Entire gain taxed as ordinary income
- Plus current 3.8% Medicare tax on Net Investment Income (NII) (assuming the requisite income thresholds have been met).

*c. Sales before August 26, 2009 (effective date of Rev. Rul. 2009-13)*

- Adjusted Basis = $64,000 premiums paid
- $80,000 sales price - $64,000 adjusted basis = $16,000 total gain
- Ordinary income portion (OI) = $14,000 (same as for surrender)
- Long term capital gain portion (LTCG) = $16,000 total gain - $14,000 OI = $2,000.

*d. Sales on or after August 26, 2009 (effective date of Rev. Rul. 2009-13)*

- Adjusted Basis = $64,000 premiums paid *minus* $10,000 COIs = $54,000
- $80,000 sales price - $54,000 adjusted basis = $26,000 total gain
- Ordinary income portion (OI) = $14,000 (same as for surrender)
- Long term capital gain portion (LTCG) = $26,000 total gain – $14,000 OI = $12,000
- Plus current 3.8% Medicare tax on Net Investment Income (NII) (assuming the requisite income thresholds have been met).

The impact of Rev. Rul. 2009-13 is to increase LTCG from a policy sale by reducing premiums paid by costs of insurance in computing adjusted basis. This is a substantial change from what was thought to be the correct method of taxation as illustrated above for sales before August 26, 2009, i.e., treating total premiums paid as the adjusted basis without reduction by COIs. On the facts of the ruling, the net effect was to tax the *entire* COIs as LTCG *in addition* to the ordinary income from CSV in excess of premiums paid and the LTCG for gain in excess of CSV. The sales proceeds will also be subject to state income taxes.

Rev. Rul. 2009-13 also covers the tax consequences from the sale of a term policy which – in essence – treats the total premiums paid as the COIs, less unearned premium for the year of sale (typically a small amount), in determining adjusted basis. As a result, the adjusted basis was reduced almost to 0, and virtually the entire sales proceeds were taxable gain. The ruling further held that this gain was all LTCG.

*e. Computation of COIs*

Obviously, calculation of COIs is critical in determining adjusted basis and consequently the correct amount of tax from the sale of a policy. Unfortunately, Rev. Rul. 2009-13 provides no explanation about how to calculate COIs. Here are some possibilities.

- Request a schedule of COIs (and premiums paid) from the insurance carrier since the inception of the policy. The carrier may or may not be able or willing to do this.

- Determine COIs (and premiums paid) from annual statements received each year by the policy owner. These may be available from the insurance carrier, or the policy owner may have kept them.
- Use IRS Table 2001-10 split-dollar term rates each year.
- Apply term rates from term policies the carrier sells.
- For whole life policies, note that costs of insurance are not separately stated as they are for universal life policies, and it's unclear how to make the COI calculations.

*f. The Bottom Line Concerning Taxes*

- It's obvious that Rev. Rul. 2009-13 has not only increased income taxes from a policy sale, but made calculation of the taxable amounts more difficult. Remember that it's the *net proceeds* from the sale of a policy, *after* income taxes and agent/broker commissions, that a client must know in comparing a policy sale with other alternatives.

- In my experience, most professional advisers are not aware that the rules have changed for making these calculations, and they may subject their clients to additional taxes and perhaps even penalties for understating income.

- A crucial service that a life settlement agent and broker *must* perform for a client is to assist the client's advisers in determining the correct taxation of the sales proceeds in a life settlement or policy surrender. Not the least of these services is helping to obtain the COIs necessary for the calculations. Caveat: We do not practice law or provide legal or tax advice, this commentary and these computations are not to be considered as legal or tax advice, they are for informational purposes only, and clients are responsible for consulting their own professional advisers for this advice.

## 7. **Regulation of Life Settlements**

Most states regulate life settlements and true viatical settlements (see "1" above, "Definition of a Life Settlement") in one fashion or another. The Life Insurance Settlement Association (LISA) website has this very helpful discussion of state regulation,

http://www.lisa.org/life-policy-owners/frequently-asked-questions ("Are life settlements legal and regulated?").

LISA says the following about regulation:

> Yes, life settlements are both legal and regulated. In 1911, the U.S. Supreme Court issued a decision in *Grigsby v. Russell*, which recognized the rights of the life insurance policy owners to transfer ownership of their life insurance policies to a third party that was unrelated to the policy owner/insured and did not hold an insurable interest in the policy owner/insured. This landmark ruling paved the way for the birth of the life settlement industry in the United States because the Court upheld a policy owner's right to assign his/her life insurance policy.
>
> As of 2015, 42 states and the territory of Puerto Rico regulate life settlements, affording approximately 90% of the United States population protection under comprehensive life settlement laws and regulations. Of these states, 31 states have a statutorily mandated two-year waiting period before one can sell a life insurance policy, while 10 states have five-year waiting periods, and one state (Minnesota) has a four-year waiting period. Most states have provisions within their life settlement acts whereby one can sell a policy before the waiting period if he/she meets certain criteria (e.g., owner/insured is terminally or chronically ill, divorce, retirement, physical or mental disability, etc.).
>
> Moreover, 20 states follow the National Conference of Insurance Legislators (NCOIL) Life Settlement Model Act, representing almost 53% of the U.S. population.
>
> Transparency is a key part of life settlement regulation around the nation. Recent laws call for full disclosure of how much compensation is earned from a transaction as well as communication of all offers, counteroffers, and rejections throughout the transaction process. In addition, most states require that consumers be provided with information about alternatives to settlements, risks related to taxation and government assistance, and the licensing of life settlement agents and brokers and providers.

> For the vast majority of states, a life settlement transaction is regulated by each state's Department of Insurance which typically requires the agent and broker representing the seller of the policy and the provider representing the buyer to be licensed by that state. Most states require all forms used in the transaction to be reviewed and approved to assure clarity and fairness. Regulated states have rules that the agent/broker and provider must follow, such as when the sale proceeds must be placed into an escrow account, or when the proceeds must be released to the seller after the transfer of ownership has been acknowledged by the carrier. In this way, the regulations protect the seller.

The LISA website also provides a comprehensive listing of statutes and regulations state-by-state, http://members.lisa.org/state-document-report.aspx, and a handy map illustrating the states that regulate life settlements and viatical settlements, http://members.lisa.org/content/2/Regulation.aspx.

As LISA notes on this map, some states regulate both viatical and life settlements; other states regulate viatical settlements only; and a few states do not regulate either life settlements or viatical settlements. Also, the states use varying and frequently confusing terminology, particularly the use of the term "viatical settlements" to encompass life as well as viatical settlements. (Please note that these references are as of a certain point in time, and you should check the current status of your state's statutes and regulations.)

Before concluding this discussion of regulation of life settlements, I'd like to briefly touch on the subject of "Stranger Owned Life Insurance" ("STOLI" or "SOLI"). STOLI was a scheme used several years back that gamed the life settlement process. (For a comprehensive background, see **Steve Leimberg**, "Investor Initiated Life Insurance: Really A Free Lunch or Prelude to Acid Indigestion?" Chapter 4, 41st Annual Heckerling Institute on Estate Planning, 2007).

There were various STOLI techniques employed. In a nutshell, the promoters of this scheme induced elderly people to apply for substantial face amounts of life insurance. The idea was to hold a policy for the policy contestability period, usually two years, and then sell the policy in a life settlement. An insured was not out-of-pocket for the premiums paid during this period because these premiums were loaned to the insured by the

promoters (or participating financial institutions), usually on a nonrecourse basis, and the policy was pledged as security for the loan. The loan bore a high rate of interest and was expected to be repaid from the life settlement proceeds from a sale after the two year period.

An insured was incentivized to participate in the STOLI transaction by being offered “free” life insurance during the two-year period, an upfront bonus of some sort, participation in the life settlement proceeds when the policy was sold, or some combination thereof. Frequently, the insured furnished false health or financial information on the insurance application at the instigation of the promoter. The end result was many lawsuits by and against the insurance companies that issued the policies attempting to rescind them for fraud and/or lack of insurable interest in the investors. Sellers and promoters have also been sued. (Many of these law suits are still pending.) To compound the problem, starting in 2008, STOLI policies could no longer be sold because of the recession with resulting adverse consequences (e.g., the loans made to purchase the policies couldn’t be repaid). The market has since dried up for STOLI policies, and currently they are virtually unsaleable. As a result, policies marketed for a life settlement today *must be* “Kosher,” seasoned, and legitimate candidates for a sale. Some states now specifically prohibit STOLI. For example, California considers STOLI to be a “fraudulent life settlement act.” (see California Insurance Code, secs. 10113.1(g)(1)(B) and 10113.1(w)).

## 8. Insurance Carrier Attitudes

Generally, insurance carriers do not like life settlements. The primary reason is that insurers, in calculating premiums, build in a “lapse factor” (an assumption a given number of policies will be dropped by the policy owner before the insured dies) in pricing their policies. Once a policy is sold to an investor, it is very unlikely it will be allowed to lapse or be surrendered before the insured’s death because the investor will want to recover its money (plus the desired return).

An insurance carrier can provide obstacles to effecting a life settlement. It may delay the process, such as the issuance of a Verification of Coverage (VOC) or changing policy ownership, both of which are required before a buyer will proceed with the purchase of the policy. The carrier may also create road blocks to obtaining new coverage if a policy has been sold in a

life settlement. In fact, some carriers may prohibit their agents from even discussing life settlements as an option for their policy owners.

**9. Missed Life Settlement Opportunities**

Why are so many policies that appear to meet the parameters for a life settlement not at least offered for sale (assuming suitability of a sale)? LISA has some compelling statistics on its website that bear on this question, http://www.lisa.org/consumer-advisors ("Did you know?").

- An astounding $100 billion+ in face value of life insurance is lapsed or voluntarily surrendered each year by seniors over the age of 65.
- A 2010 survey prepared for the Insurance Studies Institute (ISI) indicated that 90% of seniors who have let a policy lapse would have considered selling it if they had known a life settlement was an option. In addition, 49% of advisors cited lack of knowledge as the reason for not recommending a life settlement option to clients.
- A 2012 survey prepared for The Lifeline Program conducted by International Communications Research (ICR) indicated that 79% of clients feel advisors should inform them about the life settlement option. Another study conducted in 2013 by the same group indicated that 55 % of seniors allowed their life insurance policies to lapse, viewing them as a liability instead of an asset.

So, why do so many policy owners and their professional advisers seem to be missing the boat about the availability of life settlements? In a nutshell, the answer is lack of knowledge. I had a personal experience with this while making a recent CLE presentation. I asked the assembled group of lawyers how many had even heard about life settlements. Only one raised a hand. And, needless to say, no one in the room had ever advised a client about them.

A few states have enacted (or are considering) legislation requiring insurance carriers to inform policy owners of the possibility of a life settlement as an alternative to lapsing or surrendering a policy. A recent article on the National Law Review website discusses life settlement disclosure legislation and related case law, http://www.natlawreview.com/article/life-settlement-disclosure-legislation. Hopefully, this portends the future in making policy owners and their advisers more aware of the potential for a life settlement.

## 10. **Selecting a Life Settlement Agent and Broker**

Last, but certainly not least, how do a client and the client's advisers go about selecting a life settlement agent and broker? (For definitions of "life settlement agent and broker," who represent the seller, and "provider," who represents the buyer, see "Important Players" in "5" above, "The Life Settlement Process.") There are several important questions that should be asked.

*a. Do the Agent And Broker You Contemplate Using Treat this Transaction As a Security?*

When a life settlement broker supervises a life settlement transaction as a security, it means that the agent and broker are not only held to state insurance regulations governing the business but also must adhere to laws and practices relating to security transactions. This requires the agent and broker to perform such tasks as due diligence on all funding sources, full disclosure of both compensation and offers, and a negotiating process that assures best execution on every transaction. Simply put, by supervising the transaction as a security, a company can minimize the risks associated with transacting a life settlement.

*b. Are the Funding Sources Exclusively Institutional and Licensed?*

In a life settlement transaction, the policy is sold to a third-party buyer. Because the third-party receives its return on investment only when the insured dies, it is extremely important to know who is buying a policy since the buyer has an interest in the insured's death. With institutional buyers, purchased policies are held in large blind pools to assure client confidentiality (see "1" above, "Definition of a Life Settlement").

These pools may own hundreds of millions of dollars of life insurance so that performance is not based solely on the longevity of a single insured. Investors experience returns based on the performance of the entire pool of assets. With this in mind, you can see how important it is to ensure that policies are sold only to institutional funds that have undergone a rigorous due diligence process. The requirement that

providers be licensed by the state adds an additional level of due diligence.

c. *Do the Agent and Broker Work with Several Different Life Settlement Providers?*

Life settlement offers may vary widely among providers and are very sensitive to variables such as the insured's life expectancy (LE), the policy's future premium requirements, market interest rates, and the status of each buyer's current portfolio of policies.

For example, at any given time, one buyer may have a large inventory of policies insuring individuals with short life expectancies. To balance its portfolio, this buyer will need to buy policies where the insureds have long LEs. Thus, for a limited period, the buyer will have "strong money" and will make more aggressive offers on long LE policies. There are numerous circumstances that cause one buyer to have "strong money" at one point in time, and then a completely different buyer to have "strong money" only weeks later. For this reason, it is important to shop policies among a large number of providers in order to capture the "strong money" in the market at any given point in time.

d. *Does the Provider Negotiate Offers Through a Formal Written Bid Process?*

Because it is impossible to predict exactly which providers will have the strongest money at any given point in time, it is crucial to have a formal, systematic, and written process, utilizing an auction, to find this money for your client. Such a bid process forces all providers to play on the same level playing field and awards cases strictly on the merits of the provider making the highest offer, allowing sellers to know they are receiving true fair market value from the sale of their policies.

I am aware of several cases where the initial offers were only 25% of the final high offers made via a formal bidding process. This finding underscores the importance of a formal bidding process among multiple institutional funding sources in order for clients to be confident they are receiving fair value for their policies.

e. *Are the Agent's And Broker's Compensation Uniform and Capped with All Providers?*

Uniform and capped compensation assure that the interests of the life settlement agent and broker are aligned with obtaining and presenting the highest offer to your client. For this reason, both clients and their advisers should insist that the agent/broker demonstrate in writing that their compensation is both uniform and capped. For example, if compensation is not uniform with all providers, the agent/broker you are using may have an incentive to "push" business to the provider that offers them higher compensation, which may or may not be the provider that offers your client the most money. Capped compensation should be required as well to ensure that the agent/broker have a ceiling for the level of compensation they receive from brokering a transaction.

Over the years, there have been situations where providers were offered bribes (called co-brokering fees) to steer business their way at a lower price than the client would have otherwise received. This is an unacceptable practice and the reason why the agent and broker should be asked to demonstrate in writing that their compensation is both uniform and capped.

f. *Are Both the Offers and the Total Compensation Fully Disclosed?*

In addition to requiring uniform and capped compensation, a seller should demand that *all offers and total compensation to both the life settlement agent and broker be fully disclosed.* Some states require this disclosure and others do not (see "7" above, "Regulation of Life Settlements"). Full disclosure is *the most important way* to assure that your client's interests are being protected and that you are helping them make an informed decision. Clients and advisers should be proactive in seeking full disclosure of all offers on the table as well as the compensation paid to the agents and brokers facilitating the life settlement transaction regardless of whether required by state law. Only an agent and broker willing to disclose this information should be worthy of your business.

Finally, in addition to favorable answers to the preceding questions, I think it is crucial that a life settlement agent and broker also perform the following critical services.

- Undertake a thorough evaluation of the pros and cons of retaining a policy vs. selling (or surrendering) it even though policy retention (or surrender) will not result in any compensation to them (see “2” above, “The Pros and Cons of a Life Settlement”).

- Assist the client’s advisors in navigating the complex income tax rules applicable to life settlements (see “5” above, “Income Taxation of Life Settlements and Policy Surrenders”).

- Spend the time to carefully guide the client and advisers through the complicated (and frequently daunting) life settlement process (see “5” above, “The Life Settlement Process”).

- And, of course, possess the necessary experience and knowledge to obtain the best offer for your client.

**Conclusion**

A sale of a life insurance policy in a life settlement can be very advantageous where a policy owner no longer needs or wants the policy or is unwilling or unable to pay future premiums. However, a life settlement should only be undertaken after the pros and cons of selling the policy have been thoroughly analyzed and considered. Assuming suitability, a sale of a policy will frequently result in more money for the policy owner than surrendering it and certainly more money than letting the policy lapse. It is an alternative that should be considered by every policy owner where the insured is an older person and meets the parameters for a life settlement.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

*Mike Weinberg*

## CITE AS:

**LISI** Estate Planning Newsletter #2401 (March 24, 2016) at http://www.leimbergservices.com Copyright © 2016 by The Weinberg Group, Inc. All rights reserved. Reproduction in Any Form or Forwarding to Any Person Prohibited – Without Express Permission