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The Secondary Market for Life Insurance
Tools for Estate Planning Practitioners

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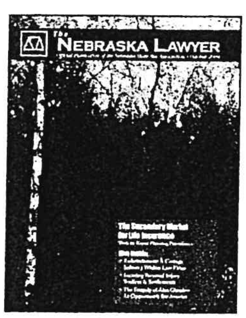
Features



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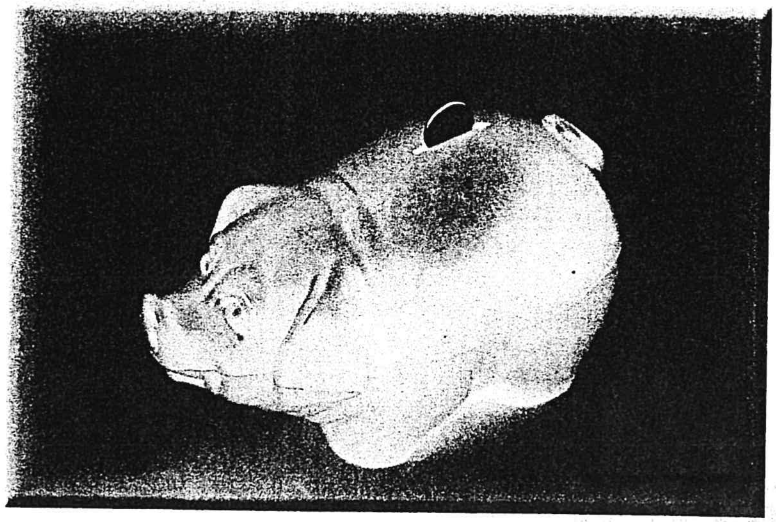
The Secondary Market for Life Insurance: Tools for Estate Planning Practitioners



by Bradford Updike, JD, CDA

Introduction

You get a phone call from your 62-year-old client who wants to let his $3 million term life insurance policy lapse. The client purchased his policy about 20 years ago so he could get a bank loan for some needed factory improvements. Due to changes in your client's life priorities, he sold his business for a great price and the loan was paid off. Now your client believes that the policy is no longer needed. After all, the additional cash flow will really come in handy in helping fund his grandchild's college tuition. As the policy is term insurance, the cash value to the client is $0 if the policy lapses. Should your client just dump the policy and leave it at that? Before venturing this path, maybe you should first consider the secondary market for life insurance. In a case similar to the one described above, one senior client was able to secure $930,000 in additional cash through this type of arrangement. *Under the right circumstances*, a life settlement could add substantial value to the professional services you give your client.

Bradford Updike, JD, CSA

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What are Life Settlements?

In its basic form, a life settlement is the sale of an existing life insurance policy that is either not performing up to the owner's investment expectations or is no longer needed.[1] Prior to the evolution of the secondary market, the non-forfeiture provisions set by the issuing company dictated the policyholder's choices. In cases involving cash-value policies, the non-forfeiture provisions provided the policyholder with essentially three basic choices: (1) surrender the policy for the cash value set by the insurer; (2) exchange the policy for a paid-up policy with a much smaller death benefit; or (3) exchange the policy for a term policy with the same face benefit. The rule is usually very simple when older term insurance is involved: you either pay the premium or let it lapse and collect nothing.[2] In the situation where the policies' market value exceeds the surrender value, sellers will realize a purchase price over and above the policy surrender value, which can help the seller to fund retirement or to purchase additional life insurance if needed.

Although the ideal candidate might have experienced some adverse change in health, terminal illness is not a necessary condition. In fact, it is not uncommon for some life settlement companies to purchase from seniors with life expectancies reaching 15 years or more. In life settlements, the policy owner transfers all of his or her policy rights directly to a purchasing company in exchange for a percentage of the policy cash value. Most companies are willing to consider life settlements for policies with death benefits of $250,000 or more.

Application Process

The price a life settlement will procure is tied to the insured person's age and life expectancy. Assuming the policy is one that can be purchased in the secondary market, the owner initiates the settlement by filling out an application with the purchasing company. Once this is accomplished, the purchasing company will obtain the insured person's medical and insurance records. With this information, the purchaser will then determine the market value of the policy, based upon the insured person's life expectancy and the discounted value of the death benefits. The settlement provider must also factor the discounted value of the premiums the company must pay once the policy is transferred as well as the return required by the company's investors.

To the extent the policy's fair market value exceeds the surrender value, the proposed settlement will provide the senior policyholder with planning options that did not exist 15 to 20 years ago. This option can be very beneficial for clients that are in desperate need of cash for long-term care needs. Where the client is still insurable, the sale proceeds can also be used to fund a paid-up policy, which could eliminate the necessity of having to fund insurance premiums on a yearly basis. These are just a few of the situations where the secondary market could be of great value to the client.

Growth of the Life Settlement Industry

The secondary market was pioneered by Coventry First and has become a multi-billion industry in a very short time-frame. According to Erich Sipple and Co., the life settlement industry alone has grown from $200 million in total policy purchases in 1998 to $1.3 billion in 2001. These statistics project that this industry could potentially grow to $12 billion in yearly purchases by 2007.[3] According to Constance Buerger, President and Chief Operations Officer of Coventry First, the growing secondary market for life insurance could provide consumers with $3.5 billion in sale proceeds that exceed policy cash surrender values. The total amount of life insurance held by 35 million seniors today has been estimated at almost $500 billion in cash surrender value. Of this, it is believed that 20% of all life insurance owned by seniors has a fair market value that exceeds its cash value. The numerous planning opportunities provided by the secondary market have translated into tremendous growth for Coventry First, who was recently named by *Inc.* magazine as the 12th fastest growing private company in the United States.

Taxation Rules

The tax treatment of viatical and life settlements are very different. In general, if a policyholder is diagnosed with a terminal or chronic illness, then the settlement proceeds are not counted in the gross income of the beneficiary.[4] However, life settlements are typically targeted to seniors who are not terminally ill, so the amount of settlement proceeds exceeding the owner's cost basis will be subject to federal and state income taxation.[5] Although the issue is not completely free of doubt, there is a belief among some tax experts that the life settlement proceeds exceeding the surrender value could be taxed as capital gain.[6] However, this position has yet to be tested in the courts.

Secondary Market Transactions

In addition to life settlements, there are two other types of secondary market transactions: Variable Annuity Rescue and Settlement with a Paid-up Policy (SWAPPSM), which are both proprietary products of Coventry First. Each of these three options is discussed further below.

Life Settlements—As described above, a life settlement is the sale of an existing life insurance policy that is either not performing up to expectations or is no longer needed. Life settlements enable policyholders to sell their policies directly to a settlement provider for fair market value. Any number of situations can create the need for a life settlement, which include the following:

- Change in policy interest rates or performance
- Change in business situation
- Estate becomes liquid enough to pay anticipated death taxes
- Estate values decrease
- Divorce
- Long-term care issues are placing a strain on the budget
- Retirement income is insufficient to cover the premiums

As these circumstances suggest, a client's financial needs can change over time. When this happens, the life settlement can become an ideal planning option as indicated in the following example.[7] The CEO of a Fortune 500 company, age 66, decided to retire due to declining health. As part of his retirement plan, he was given the choice of keeping his life insurance policy or taking its $900,000 in cash value. Upon the advice of his attorney and accountant, he was advised that he needed survivorship insurance for estate planning purposes. Through a life settlement, the client received $2 million from the policy sale. With the help of his financial advisors, he deposited $1 million into a 10-year annuity that financed a $5 million survivor policy for anticipated estate taxes. The remaining $1 million became an additional retirement benefit for the client.

Life settlements can also benefit those who are well into their senior years. In another case example, a senior female, age 83, owned multiple whole life and universal life policies with a total death benefit and cash value of $12 million and $2.4 million, respectively. These policies were not performing up to expectations, and the client needed additional insurance for estate planning purposes. By selling the policy to a settlement provider, the client received a total of \$4.3 million, part of which helped to fund a new policy with a \$15 million death benefit. Although the cost of the life insurance was higher due to age, the premium outlay was actually about 30% less after the income from the \$4.3 million was considered.

Estate and business planning attorneys who have been practicing over the past 5 to 10 years will likely be familiar with the split-dollar life insurance policies that emerged as a popular employee benefit in the 1990s. A split-dollar plan is an arrangement where the employer and employee usually share in the cost of a life insurance policy. In many cases, the employer picks up most of the premium costs. Under the former income tax rules, this arrangement provided employees with a tax-advantaged life insurance benefit to meet family needs, and it also provided employers with a tax-deductible way to provide key employees with better benefits. A secondary benefit of these arrangements also hinged upon the potential tax-deferred accumulation of cash value for retirement needs.

Unfortunately, many of these split-dollar policies have not performed as expected due to higher financial market volatility over the past three or so years. Additionally, the IRS has changed the rules on these arrangements, making it much more difficult for employers and employees to benefit from an income tax perspective. These circumstances have motivated many to drop these policies in favor of other tax-advantaged options. Before your client decides to drop a policy under their split-dollar plan, it might be in their best interest to first consider a life settlement. Under the right set of circumstances, this alternative could offer more value than simply cashing out for the surrender value.

Variable Annuity Rescue—Heavily promoted as an effective strategy for retirement, variable annuities increased in popularity over the last 20 years. On the other hand, volatile markets and high fees have impaired the investment performance of these contracts. With Variable Annuity Rescue, clients are given the opportunity to sell their variable annuities and to receive market value in return. Variable Annuity Rescue can potentially provide a return high enough to offset the surrender charges, giving clients a practical way to free themselves of an under-performing asset.

Over the past few years, the investment value in many annuities has dropped significantly. As a result, the death value of these contracts may be considerably higher than the investment value. Under the right circumstances, Variable Annuity Rescue can allow the investor to capitalize on the market value of the underlying death benefit.

An example of how the annuity rescue can be effectively used is illustrated by the following case example. A client funded a variable annuity with a \$500,000 initial deposit. The death benefit was set at \$1 million, and the cash surrender value was at \$635,000. The yearly management fees charged by the annuity company were about \$13,000. Through Variable Annuity Rescue, this client received \$675,000, which was \$40,000 more than the cash surrender value. The client then used the proceeds to purchase an immediate annuity that funded a \$2 million trust-owned life insurance policy. In the end, the client was able to procure more life insurance than provided under the old annuity contract.

In most cases, Variable Annuity Rescue will require the owner to be age 65 or older, with a:

- Non-qualified variable annuity contract
- Dollar for dollar withdrawal provision
- Maturity provision of age 90 or older
- Death benefits exceeding the annuity value by \$50,000 or more

Settlement with a Paid-Up Policy (SWAPP)—This option is designed for clients with under-performing life insurance policies that still desire insurance but no longer want to pay premiums. This option allows the client to receive a guaranteed paid-up policy based upon the one-time premium paid from the market value of the original policy. As a practical matter, this option is subject to the same underwriting requirements as a life settlement. To qualify for this option, an owner should meet the following requirements:

- \$500,000 minimum face amount *(any type of policy can qualify)*
- Life expectancy of 15 years or less
- A change in insurability since the original policy was issued

An example of how this can benefit a client is illustrated by the following example. A client needed to continue life insurance, but wanted to eliminate premiums and have a paid-up death benefit. A \$2.9 million reduced paid-up policy was available from the issuing carrier. The client's life insurance agent suggested that the policy be appraised. Based on the market value of the policy, this provided a paid-up policy in the amount of \$3.4 million. It was a win/win situation for the client. The client eliminated premiums and had a paid-up policy on a guaranteed basis with a face amount of \$500,000 over what the insurance company would have offered.

Other Business and Estate Planning Considerations

Helping a client to acquire a business at the best possible price clearly enhances the overall value of the attorney's services. Having knowledge of the secondary market for life insurance can give business-planning professionals a leg up on ➡

their competition. Consider the situation where the assets of the target company include life insurance policies of the senior owner or other key senior employees. Rather than merely cashing the policies out for their surrender value, one should realize that these policies may have a market value that exceeds the surrender value. As such, these policies could clearly represent a hidden additional value to the business purchaser.

In the estate-planning arena, a client's transfer of property can be subject to a look-back period for federal estate tax purposes. For example, the transfer of an existing life insurance policy prior to death is typically subject to inclusion in a decedent's estate if death occurs within a three-year period from the time of transfer. A qualified personal residence trust ("QPRT") could also present certain estate tax consequences. A QPRT allows the grantor to reside within the personal residence for a specified number of years, after which title passes to a designated younger-generation beneficiary. Although a small gift tax could be generated on the transfer, the bulk of the property value is eliminated from the estate through the transferred remainder interest. For this strategy to work, however, the grantor must survive the entire duration of the term-of-years interest or the date of death property value will be included the estate. To hedge against the risk of an early death in both situations, grantors sometimes purchase either a term or minimum premium universal policy to cover the potential estate tax. After the grantor has survived the needed period of time, the insurance is often dropped because it has served its short-term purpose. Rather than letting a policy just lapse, one should realize that the secondary market for life insurance could provide a substantial benefit to the policyholder.

Responses from the Insurance Industry to Secondary Market Pressures: Accelerated Death Benefits

Before the emergence of the secondary market for life insurance, the only meaningful buyer for a life insurance policy was the issuing company.[8] However, the rapidly developing secondary market has kept life insurance policies in force. In response to the rapidly-growing secondary market of the 1990s, life insurance companies developed accelerated death benefits ("ADB"), which give policyholders the option of receiving anywhere from 25% to nearly 100% of their death benefit while they are still living. To qualify for the ADB, a policyholder must have a living death benefit rider on the policy and, depending upon the policy, either suffer from a serious illness or require immediate long-term care.[9] Although the required life expectancy for ADB coverage varies from company to company, 12 months is the most common maximum life expectancy. Furthermore, only about 5% of the ADBs on the market today allow policyholders with life expectancies exceeding a year to accelerate death benefits.

The increase in policies with ADB benefits has followed the growth of the secondary market, as life carriers began to add them to policies with increasing regularity in the mid and late 1990s According to the *LIMRA International Study*, approximately 39.9 million policies contained ADB riders, which was double the amount of ADB riders in 1994. Interestingly, ADBs have become cheaper and easier to obtain over the last decade. In 1990, nearly 90% of the ADBs required additional premium payments. However, this number decreased dramatically by 1998, as only 13% of the policies with ADBs required an additional premium for the coverage. From an income tax standpoint, proceeds received from ADBs are usually excluded as taxable income when the policyholder has been diagnosed with a chronic or terminal illness.[10]

Notwithstanding the recent willingness of life insurance companies to offer ADBs, they are not substitutes for life settlements because the life expectancy requirements differ greatly, and a relatively healthy senior with a need for quick cash could find the ADB to be of no immediate help. With this said, estate planning practitioners should be mindful of the additional planning opportunities that the secondary market provides for seniors with stable health and extreme cash flow needs.

A Brief Word about Regulation

One of the biggest ethical criticisms of the secondary life insurance market is the notion that investors are waiting for a person to die, and the sooner the person dies the greater the investor's rate of return.[11] Additionally, there are arguments that seniors with dementia and other cognitive defects are easy prey to deceitful business practices. On the other hand, there are many ethical secondary market investors and purchasers who are helping those who either can't afford or no longer have a need for their life insurance by providing them with an alternative not otherwise available under the non-forfeiture provisions of many policies.

In response to the public's ethical concerns, the senior life settlement industry has increased its focus upon establishing regulatory initiatives to protect elderly consumers. In 2001, the Life Settlement Coalition was formed with the purpose of educating seniors about life settlement options. Additionally, the Viatical and Life Settlement Association of America (VLSAA) is another group that focuses on regulatory initiatives in the secondary life insurance market.

In addition to the initiatives above, a number of states, including Nebraska, have adopted versions of the Viatical Settlements Model Act ("Model Act") to protect consumers and to provide a statutory mechanism to regulate secondary market activities.[12] Unlike the laws in many states, the version adopted by Nebraska is applicable to viatical and life settlements alike. Under Nebraska law, policy brokers and policy purchasers must be properly licensed with the Nebraska Department of Insurance. Additionally, brokers and purchasers must adhere to certain disclosure rules that inform the policyholder of, among other things, possible alternatives to a life settlement (such as ADBs) and the potential tax consequences of the transaction.

Conclusion

The professional and fiduciary obligations of the legal professional include the need to treat life insurance policies as property on par with a client's other financial assets.[13] The simple fact is this: a client's financial needs could change over time and the circumstances that necessitated the need for a life insurance policy 10 to 30 years ago may no longer exist today. Also, where the need for life insurance is continuing, the decrease in income that often accompanies retirement might require a creative solution that will continue the coverage and eliminate the continuing premium obligation. It should also be remembered that most seniors who receive ongoing long-term care are getting these services at home. Unfortunately, Medicare does not cover most of these services. Medicaid may also be an undesirable alternative for many clients due to income and asset spend-down requirements. Where the benefits of an ADB rider are lacking, the life settlement can potentially provide a source of funding to help the client remain as independent as possible for as long as possible. Although I am not advocating that seniors should go out and sell their life insurance in all cases, one should be careful not to overlook the potential benefits in cases like the ones mentioned above.

Aside from the economic benefits, state regulation like those adopted here in Nebraska should encourage involvement from the legal community. Before a senior enters into a life settlement, they should be aware of the various implications of entering into such an arrangement. For example, creditors rights can potentially limit the ultimate benefit received by the policyholder. Other alternatives, such as an ADB, can potentially be a better course of action for a client with a serious illness. Tax consequences should be closely considered in the process, and due diligence should be performed to ensure that the client is dealing with an established company. Another consideration that clients should be aware of is that confidential information and medical records in some cases could be shared with third parties if the policy is later sold by the purchasing company. Meaningful consultation with an attorney will often alleviate some of these questions and other concerns an individual may have about the life settlement process. Notwithstanding the potential for monetary gain, attorneys can provide a substantial benefit by ensuring that their clients are well informed in their decision to pursue a life settlement.

Endnotes

1 Coventry First, *Understanding Life Settlements*, www.coventryfirst.com/ls (July 27, 2004).

2 Term policies issued after 2000 could include a return of premium benefit.

3 Alan H. Buerger, *Life Settlements Come of Age*, Trusts & Estates, p. 33 (November 2002).

4 26 U.S.C.A. §101(g)(2).

5 26 U.S.C.A. §101(a)(2).

6 Morton Greenberg and C. Andrew Graham, *Life Settlements: A New Option For Excess Life Insurance*, 31 OCT. COLAW. 99, 102 (Oct. 2002).

7 Coventry First, Case Examples, www.coventry.com

8 Doherty, supra note 3, at 466-67.

9 *Id.* at 467, fn. 44.

10 26 U.S.C.A. §101(g)(1).

11 Perez, supra note 2 at 447-48.

12 Joseph C. Vitek, "Nebraska's Viatical Settlements Act," *The Nebraska Lawyer* (Oct. 2003); Neb.Rev.Stat. §§44-1101 to 44-1116.

13 Dean Edward Miller, "Life Settlements and Trust Accounts: A Possible Modification of the Trustee's Responsibility?" *The Banking Law Journal* (May 2002).