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New Value in Old Policies

LIFE SETTLEMENTS

By Valerie Greenberg

Fast Facts:

Life settlements are the purchasing of existing life insurance policies of seniors over 65 for more than cash surrender value.

Any time a business is transferring ownership, there may be a key person policy that is no longer needed and can be sold.

The insurance company that issued the policy must be well rated and the policy cannot be contestable.

Life settlements, also referred to as senior settlements, are the purchasing of existing life insurance policies of seniors over 65 for more than cash surrender value. There are now companies funded by institutional money whose sole business is purchasing these policies. Dropping or surrendering a policy with this option now available could be costly.

Life settlements are not to be confused with viaticals, which are the purchasing of policies of the terminally ill. Viaticals are more based upon health, while life settlements are based upon age. A life settlement company will not purchase a policy from a terminally ill person.

Institutional funders view the policies as an investment in an asset they can hold for a number of years. That is one of the reasons why institutional funding is key. Once the policies are purchased, they are held in a large pool of policies, so one policy has no more importance than another, unlike when policies are purchased by an investor. The policies are not resold; you know where the policy will wind up. The policies are purchased, serviced, and the client is tracked in a manner that meets the guidelines of the National Association of Insurance Commissioners (NAIC).

Because the parameters for a life settlement are age related and life expectancy is longer than that of viaticals, life settlements have become an essential planning tool for many areas.

Bankruptcy

The sale of a key person policy owned by a corporation could bring more money for satisfying the claims of creditors. In a reorganization situation a company may also want to raise cash by selling any policies no longer needed.

Trust Administration/Estate Planning/Financial Planning

There are many reasons why a policy may no longer be desirable to keep in place. Some of them are:

- original reason for purchasing the policy is no longer there
- beneficiaries are deceased
- another investment would make more sense at this time
- a reduction in estate size or a change in the tax laws
- the premiums are no longer affordable
- a policy purchased years ago may not be performing as expected

Many policy owners believed dividends on policies they purchased years ago would be covering premiums. Now the interest rates are much lower and higher premium payments are going to have to be paid or the policy will lapse. Until life settlements came along there were three alternatives:

- Use the cash surrender value to fund the premiums.
- Reduce the face value of the policy.
- Drop the policy if there was no cash value, or surrender the policy for the cash value.

An attorney used a life settlement to solve a problem within a trust. A 65-year-old had multiple policies in the trust. Two were $5 million, both term. Previously one had been converted. The maximum gifting allowance was not enough to keep both policies in force. The solution was that the nonconverted policy was sold for enough cash to pay premiums on the converted policy and also freed gifting allowances to be used elsewhere.

Charitable Giving

Many policy owners would consider donating a policy to their favorite charity. However, the charity may not want to take on the responsibility of paying premiums to keep the policy in place and the policy owner does not want to keep up premiums. With life settlements neither has to.

A 76-year-old policyholder wanted to donate his $750,000 policy to his favorite charity. The charity would take on the premium obligation and he would be able to write off his cash surrender value of $142,189. His advisor helped him look into a life settlement and the policy was subsequently sold for $225,000. The charity received the cash immediately and had no further premium obligations. The donor was able to take an additional $82,811 charitable donation.

Business Succession

Any time a business is transferring ownership there may be a key person policy that is no longer needed and can be sold.

Sale of a Business

As an example, a corporation owned life insurance totaling $10 million on the key people. Some of it was permanent, but most was term. The cash surrender value totaled $800,000. The policies would have been dropped or surrendered with the completion of the sale. The offer to purchase the company fell $1 million short of the desired sale price. A life settlement of $3.5 million on the policies, combined with the offer to purchase made the sellers of the company happy to accept the offer on the sale of the company.

There was another case where a company was being sold. One of the assets was a key man life insurance policy on the owner. Neither the owner nor his advisor knew about life settlements and didn't think the policy was worth much. They let it go to the purchaser of the company as part of the assets. The new owners of the company sold the policy for almost as much as they paid for the business.

Buy/Sell Agreements

When any change has made the buy/sell funding no longer necessary, more may be obtained for the policy than surrendering it.

Retirement

An example of this would be the retirement of a company president of a closely held family corporation. The company owned a $3 million term policy on him. The premiums were $12,000 and about to increase. The policy was sold for $600,000.

Merger and acquisition and ESOPs are other business transfer situations where a key person policy could be found that may no longer be needed.

Commercial Lending

When a life insurance policy has been taken out for purposes of a loan, after the loan has been paid off the sale of the policy could be considered.

Divorce

In such cases where the cash surrender value of the policy is being treated as an asset subject to equitable distribution, if the insured is over 65 a life settlement may bring more money than surrendering the policy.

Another situation where selling a policy could make sense is company-owned policies that had been purchased to fund deferred compensation or retiree benefit programs. After the programs have been changed and the policies are no longer needed, life settlements could be looked into.

Policy Parameters

Any type of policy can be considered. Whole life, universal life, variable life, survivorship, adjustable life, group policies, and even term life policies. The insurance company that issued the policy must be well rated and the policy cannot be contestable.

Purchase price or whether an offer can be made at all is based upon the type of policy, face amount, age of the insured, any outstanding loans, and the amount of the premiums since the purchasing company will have to continue to pay on the policy. The life expectancy of the insured is also taken into account based upon age and medical records. No physical exams are required.

Each life settlement company has different parameters. Some will look at policies with as low as $50,000 face value while others may only look at those over $250,000. One company may only purchase policies whose insureds have a life expectancy up to 10 years, while another company may go up to 15 years. Maximum face amount of the policy each company can purchase also differs.

Each life settlement company also uses a different formula to determine how much they will pay for a policy. One company may not make an offer at all and two others may, but the offers will be different. A life settlement broker checks around for the best offer.

Examples of Life Settlement Transactions

Face Amount	CSV	Age	Settlement
$500,000	0	68	$25,000
$4,000,000	$90,000	82	$1,430,000
$4,700,000	$1,250,000	82	$1,350,000
$200,000	$49,000	75	$66,000
$5,000,000	$5,236	74 & 82	$660,446
$750,000	$142,189	76	$225,000

As can be seen by these examples, there is no set percentage of face amount. It depends upon the criteria of that particular case.

What Can Be Done With the Proceeds

The settlement is paid in a lump sum and the proceeds can be used in any manner the client wishes:

- to purchase a more cost effective policy
- to purchase long term care insurance
- to buy back stock from a partner or stockholder
- to purchase another investment
- to pay gift taxes generated from gifting other assets
- to fund a charitable gift
- for cash for supplemental income

When insurance coverage is still needed and a policy is performing poorly or premiums have become unaffordable, a specific program used with the life settlement to replace coverage may be used. It may be able to offer cost effective coverage with guarantees while getting cash out of the old policy.

A case example is that of an 80-year-old female that sold a $5 million policy. She put $708,000 in the bank after purchasing another $5 million policy with a premium that was guaranteed for 10 years and a guaranteed payout of $5 million at death or the end of the 10 years if she is still living. She also went from an approximate $150,000 premium on the old policy to a $92,000 premium on the new policy.

Tax Implications

For individual policy sellers the amount of the settlement equal to premiums paid would be their basis and no tax is due. The amount between their basis and cash surrender value would be taxed as ordinary income. The remainder would fall under capital gains. Policy sellers should consult his or her own advisor regarding their tax consequence.

The existence of life settlements leaves a new option to be considered and explored anytime there is a life insurance policy in place. ✦

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