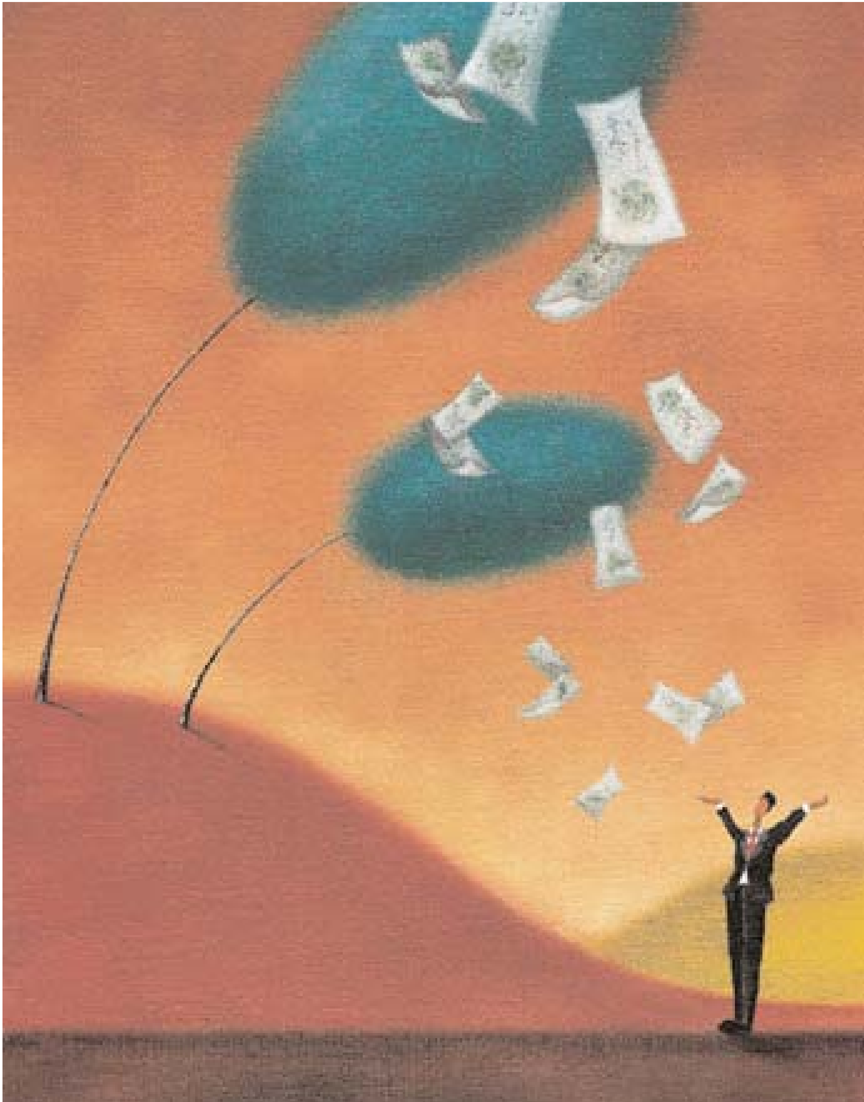
A Hidden Asset

How clients can turn life insurance into cold, hard cash while they're still alive. By Roccy DeFrancesco



SAY DR. SMITH HAS A 20-YEAR TERM LIFE insurance policy, which is nearing its deadline to convert to a whole life policy. At 79, Dr. Smith can't afford to pay the astronomical price to convert the policy. A widower with grown children, he doesn't need the insurance for his heirs. Nor does he want to let the $250,000 policy lapse, leaving him with nothing but thousands in premium payments down the drain.

You could offer Dr. Smith another option that many planners outside the insurance business don't know about. That is, he could sell his insurance policy to a life settlement company for, say, $75,000, and recover all of the premiums he paid plus a nice profit.

Most people buy life insurance policies to protect the family in case the breadwinner dies, to pay for estate taxes, or to help offset expenses associated with replacing a key corporate executive. But when children are grown or the executive has moved on, the reason for paying those premiums lapses. Clients often continue to pay expensive premiums out of habit. It doesn't occur to them that they could stop, let alone make money on these policies. Many planners outside the insurance industry don't know about this option either. But selling a life insurance policy under the right circumstances could help your clients as much as purchasing one when they need protection. Life settlement agreements offer planners another tool to help clients with their insurance needs. For retirees, in particular, selling an existing life insurance policy can be a quick and harmless way to raise cash.

DOUBLE BENEFIT

Life settlements haven't hit the mainstream yet, but as the society ages, they may play a more prominent role. The life settlement market first emerged in 1998 and has been growing at an annual rate of just under 20%, according to Conning Research and Consulting, a financial services firm in Hartford, Conn. In 2003, the Census Bureau reported that 35.9 million individuals aged 65 and over owned a life insurance policy. By that time, the face value of policies sold in life settlement deals amounted to more than $2 billion.

This market is only going to increase. In an aging society, it's particularly important that advisers understand that clients can get cash benefits out of an insurance policy in excess of the benefits they put in—while they're still alive. Also, life settlements provide a double benefit: clients not only get a lump sum to spend but save the money they would otherwise spend on the premiums to keep up the policy.

Life settlements are not the same as viatical settlements, which are sold by someone with a terminal illness. Viaticals typically fetch more money because they pay off much sooner, but they have been tainted by a series of recent scams.

Life settlements can carry little risk for the seller who no longer needs the insurance. Typically, the client or his adviser will apply to a broker or directly to a life settlement company, usually a bank or lending

Settling the Taxes

An example is the best way to show the tax consequences of a life settlement. Assume a $1 million policy issued 10 years ago and a $400,000 settlement amount paid to the policyowner. The policyowner paid $150,000 in premiums over 10 years. If the basis (premiums paid) is less than the cash surrender value, the difference is taxed as income. Any additional profit is taxed at the capital-gains rate.

	$400,000	Life Settlement
-	$150,000	Tax Basis (premiums paid)
=	$250,000	**Profit**

Of the $250,000 profit:

	$175,000	Cash Surrender Value or Tax Basis Plus Earnings
-	$150,000	Tax Basis
=	$ 25,000	**taxed as Ordinary Income**
	$225,000	**taxed as Long-Term Capital Gain**

institution, which reviews the application and makes an offer. Planners want to look for reputable life settlement providers or brokers that are backed by solid institutional funding. And the offer must be more than the cash surrender value of the policy for the transaction to be worthwhile.

Through a life settlement, clients can sell any kind individual life insurance policy, including term, whole life, universal life, variable, and second-to-die. But a purchasing company will be looking for the client to be at least 65 years old and the policy to have a minimum of $100,000 of initial face value for the death benefit. Life settlement companies will usually pay more for policies whose owners are in declining health. The policy typically has to be in force for at least two years and the client expected to live for at least two years. Purchasers ideally want clients with a life expectancy of less than 12 years.

MULTIPLE USERS

There are numerous situations where planners might want to consider recommending a life settlement. Often, like Dr. Smith, the client can't afford the conversion from term to whole life or a client's income may significantly decrease so he or she can no longer pay the premiums. Planners might also consider a life settlement when a client's estate planning needs change. If, for example, a couple bought a policy to cover estate taxes, but the estate is small enough to escape any tax liability.

A life settlement can also play a role when the insurance isn't sufficient to cover estate taxes. One elderly couple, for example, had a $2.2 million policy held in an insurance trust covering the wife. They had invested well and their estate had increased enough so that the death benefit on the policy no longer covered their growing estate tax liability. The couple's adviser suggested that they sell the life policy for $450,000. They used part of the proceeds to pay for a new, $4 million joint survivorship policy. The husband was in great health, and the second-to-die life insurance policy was significantly less expensive than the original insurance.

Life settlements can also serve to supplement clients' income in retirement. A big spender might be able to maintain his or her lifestyle by trading in a 20-plus-year-old life policy for a bundle of cash that could be reinvested, perhaps in an immediate annuity for a guaranteed cash flow for the rest of the client's life.

Clients may also be able to raid the insurance cookie jar to pay for needed medical expenses. Take the example of Roger, a 76-year-old who had just suffered a stroke that left him permanently disabled. His family was unprepared for the cost of the healthcare facility. Fortunately, Roger owned a $500,000 life insurance policy, so his adviser suggested the family look into a life settlement. Roger sold the policy for $250,000. This not only eliminated the need for future premium payments on that policy, but also covered the Roger's nursing home costs for the three years until he died. The remaining cash was distributed to Roger's original beneficiaries.

Life settlements also make sense for companies that no longer employ executives on whom they carry key-man insurance. Say a company owns a $5 million policy on an older executive who had retired three years earlier. The surrender value was $600,000 and the company no longer wished to make the $90,000 annual premium payments. The adviser recommended a life settlement that offered the company $1 million for the policy, or $950,000 after taxes. Thus, the company received significantly more than the policy's cash surrender value.

Life settlement payments may be taxable depending on the cost basis of the policy, the cash surrender value, and the amount received from the purchaser. If the settlement amount is less than the cost basis, there should be no tax liability (see "Settling the Taxes," at left).

Most advisers don't have direct relationships with companies that specialize in purchasing life policies so they apply on behalf of their clients to a broker, who shops the life policy around. Generally speaking, the broker can negotiate with the policy buyer a "commission" of approximately 6% of the death benefit of the policy. For example, if the client's life insurance policy has a death benefit of $1 million, $60,000 goes to the broker—an amount the broker doesn't usually disclose to the adviser. Brokers can take up to 50% of the available commission.

If the broker can be cut out, both the client and the adviser can receive more money. A number of life settlement companies will work directly with advisers, including Peachtree Life Settlements (www.lumpsum.com), Legacy Benefits Corp. (www.legacybenefits.com), and Coventry First (www.coverntryfirst.com).

As the population ages, Life Settlements are likely to become a standard option advisers suggest to their clients. In the meantime, it can only help your practice to be ahead of the curve. **FP**

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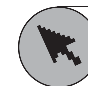

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