Course Objective

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners, insurance advisors) about a recent and much overlooked area of consulting, "Life Settlements." Advisors are supposed to assist clients with some or all of the following topics: estate plans, personal and business taxes, insurance and finances. When looking at the previous list the topic of life settlements does not seem to jump off the page as a logical topic that would come up when dealing with any item on the list.

This course will cover why clients in a variety of situations could benefit financially or from an estate planning perspective by using life settlements or viatical settlements. This course will also give several real world examples where a life settlement can be of service to clients.

Life Settlements

Introduction

For many advisors (especially those not in the insurance industry) the concept of selling an existing life insurance policy is new. Just asking the question sounds strange. Why would a client want to sell a life insurance policy?

The concept behind Life Settlements is fairly simple. Life Settlements are for someone who purchased a life insurance policy in the past, no longer needs that particular policy (for a variety of reasons discussed below), and would like to sell the policy today for **cash** and use the proceeds for any number of different purposes. Typically the seller is over the age of 65. For the life settlement to be financially viable for the seller, the seller must receive more than the "cash surrender value" (CSV) of the policy. If the amount that would be received is less, there is no need to sell the policy when the client can simply surrender the policy to the carrier for its CSV.

The concept of buying or selling a life insurance policy has been around for some time, mainly in the form of a viatical settlement, which is the purchase of a life insurance policy of a terminally ill person who is going to die typically within two years. The buyer purchases the policy at a discount (an amount which is less than the death benefit), and the person selling the policy gets cash now to improve their life before passing away. To many clients viatical settlements might be an interesting investment option; but the concept as a seller will not be applicable unless the seller is terminally ill.

Viatical settlements have become a lot less popular due to the highly publicized amount of fraud that occurred in the industry over the last several years. The topic really has been tainted for the time being. Therefore when insurance agents specifically discuss life settlements today, they are mainly referring to a client who is in good health but simply does not need their life insurance policy for whatever reason.

Why should all advisors learn about life settlements?

While most educational material you will read on any number of topics will simply discuss their mechanics and finances, this material was designed to give readers more.

One key issue for advisors (especially CPAs, accountants, EAs, trust officers and attorneys) is that of fiduciary duties. Most advisors act in a fiduciary role to protect the client and have a duty to offer the best advice possible to a client.

When your read over the following material, keep in mind your fiduciary duties to your clients and think about how those duties in the past might have been breached (although there might not be a standard of care on this issue yet) because the issue of Life Settlements was not discussed with a client age 65 or older.

It is this author's opinion that anyone doing estate or financial planning for clients over the age of 65 should have on their estate or financial planning checklist a box for Life Settlements which can be checked off after discussing the topic with a client.

Why sell a life insurance policy?

I think a better question is why should clients keep life insurance policies they have no need for. That question brings us to the age old question of why and when should someone buy a life insurance policy. There is an entire discussion about when, how much and what type of life insurance a client should purchase in the educational module on life insurance. As a quick summary for this material, there are three main reasons why clients buy life insurance:

> 1) To protect the family in case the "breadwinner" (parent who makes the most money) dies. This protection covers the non-working (or working at a lower income level) spouse who will want to have his/her debts paid off and money to live on. There is typically a need to protect the children so the living parent can buy food, clothing, and put the children through college.

2) To pay for estate taxes so wealth can be passed to the heirs at the second spouse's death. Most physician clients will **not** implement proper estate planning; and, therefore, the cure-all is to purchase life insurance to pay for estate taxes (assuming the physician and spouse do not both die in 2010 when there is no estate tax).

3) To help offset expenses associated with replacing a key executive of a corporation.

Therefore when an advisor is looking to determine if a Life settlement is a good option for the client, the advisor must determine if the original need for the life insurance still exists.

What type of life insurance policies make sense when considering a life settlement?

The simple answer is that any "individual" life insurance policy can be sold through a life settlement. This includes:

-term;
-whole life;
-universal life;
-variable;
-survivorship;
-adjustable; and
-joint first-to-die policies.

For the policy to be something a purchasing company would find worthwhile, the policy should generally have a minimum of $100,000 of initial face for the death benefit.

As a good rule of thumb, the client should be over the age of 65 years old and it is helpful, in order to receive the highest possible purchase price, for the client to have had a change in health since the policy was issued (health has deteriorated).

Also, it is typically required that the policy be in force for at least two years and that the client is expected to live for at least two years. Further, the purchaser would ideally like to see a client with a life expectancy of less than 12 years.

When would a client consider selling a life insurance policy?

1) When Clients have insurance and/or estate needs that have changed, which makes their current policy(s) inadequate or excessive for their current or future needs.

An example of this would be a client who bought the insurance to cover estate taxes and, for various financial reasons, the client's estate is small enough that estate taxes are not an issue (or if a miracle happens and the estate tax is repealed).

A second example would be if the intended beneficiary of the policy predeceased the client. If the client bought the policy to benefit the spouse and the spouse died prior to the client, there is no need for the policy and therefore no need to continue to pay premiums. The same would be true in the unfortunate circumstance of a child predeceasing a parent.

A third example would be for a life policy that was purchased to pay off a loan in the event of death. Once the loan is paid off, there is no need for the insurance and therefore it would make sense for a client to look at a Life Settlement as a way to maximize the present value of the life policy.

2) When premiums on the policy are no longer affordable.

Many clients will get to a point in their lives where their income significantly decreases. When this happens, many will not be able to continue to afford to pay the life insurance premiums that were once affordable when gainfully employed. The clients can surrender the policy, decrease the death benefit and premiums, or the client could choose to sell the policy for cash and eliminate the painful insurance premium payment.

3) When clients are not satisfied with the performance of the insurance product(s) they have chosen, or are aware of newer, better performing insurance products.

This is quite a common occurrence due to the fact that life insurance costs have never been lower. Combine the lower expenses with the better designed cash building policies and many clients could benefit by replacing their current policies with a new and improved policy.

4) When clients choose to realize the value of their policy(s) now, rather than continuing to pay on a policy from which they will never receive benefits.

An example of this would be clients who have been paying premiums on policies for years not because they actually have a need for the insurance, but simply because they were mentally conditioned to pay and no one told them they could stop. Once clients realize the ability to stop paying and the ability to sell the policy for cash in hand, many will opt for the cash now and no future premiums.

5) When clients, or owners of a company, own key man policies that are no longer needed, or elect to use the sale of the policy(s) to enhance a buy-out or create severance packages.

What is a client to do with a key man policy that is no longer needed? The answer many times is to surrender the policy for cash or let the policy lapse. Once a client realizes the ability to simply sell the policy for more cash than the cash surrender value, most clients will opt to sell the policy.

6) When clients wish to live out the remaining years of life without a change in lifestyle.

This is the classic situation where you have a client that has been paying on a policy for 20+ years and is now in retirement. The client may or may not have an estate tax problem, but because of a particular life style, the client does not have enough money to live the accustomed lifestyle until the presumed date of death. In order to help our clients maintain that lifestyle, an option for the client is to sell their 20+ year old life policy for a nice amount of cash. Then that cash can be re-invested (maybe in an immediate annuity) so the client can have a guaranteed cash flow for the remaining years of life.

7) When clients need capital to pay for medical treatments or procedures.

Unfortunately, this is becoming far too common. Many clients cannot afford their health insurance bills (which includes prescription drugs). The client has minimal assets and doesn't realize that the best asset in hand is the life insurance policy he has been paying on for many years. If clients knew that they could sell such life policies for more than the cash surrender value, many would so they could have enough money for proper medical care.

8) When any client realizes that there is now a greater tangible asset value to their life insurance policy, and wishes to take advantage of this added value

This is simply an example of greed. The client reads about or hears about life settlements and determines that the policy is worth more in hand through a Life Settlement, and the client sells the policy to get the money.

Statistics about the life settlement market

The U.S. Census Bureau, 2003 reported that 35.9 million individuals age 65 and over own a life insurance policy. Already, the face value of policies sold in Life Settlement transactions amounts to more than $2 billion, according to Conning Research and Consulting, a financial-services firm in Hartford, Conn. The life-settlement industry is growing at an annual rate of just under 20%.

This market is only going to increase as the baby boomers start to reach age 65 and beyond. With the fact that our society is getting older, understanding and dealing with the topic of life settlements is vitally important for any advisor who is trying to provide estate planning or financial planning advice to clients.

Who is involved in Life Settlements?

1) The Policyholder (our client)

2) A Life Settlement Broker

3) The Provider (the purchaser)

For a better understanding of those in the life settlement process and so readers have an understanding of the needed terms, the following definitions are provided from the NAIC Viatical Settlement Model Act and Regulation. The NAIC has expanded its regulation of viaticals (regarding the sale of policies by terminally ill individuals) to include the sale of any policy. More specifically, in its Model Act and Regulations, the NAIC defines the parties, in relevant part, as follows:

Viator: means the owner of a life insurance policy or a certificate holder under a group policy who enters or seeks to enter into a viatical settlement contract. For the purposes of this Act, a viator shall not be limited to an owner of a life insurance policy or a certificate holder under a group policy insuring the life of an individual with a terminal or chronic illness or condition except where specifically addressed.

Viatical Settlement Broker: means a person that on behalf of a viator and for a fee, commission or other valuable consideration offers or attempts to negotiate viatical settlement contracts between a viator and one or more viatical settlement providers. Notwithstanding the manner in which the viatical settlement broker is compensated, a viatical settlement broker is deemed to represent only the viator and owes a fiduciary duty to the viator to act according to the viator's instructions and in the best interest of the viator. The term does not include an attorney, certified public accountant or a financial planner accredited by a nationally recognized accreditation agency, who is retained to represent the viator and whose compensation is not paid directly or indirectly by the viatical settlement provider or purchaser.

Viatical Settlement Provider: means a person, other than a viator, that enters into or effectuates a viatical settlement contract. Viatical settlement provider does not include:

(1) A bank, savings bank, savings and loan association, credit union or other licensed lending institution that takes an assignment of a life insurance policy as collateral for a loan;

(2) The issuer of a life insurance policy providing accelerated benefits under Section [refer to law or regulation implementing the Accelerated Benefits Model Regulation or similar provision as addressed by the NAIC)] and pursuant to the contract;

(3) An authorized or eligible insurer that provides stop loss coverage to a viatical settlement provider, purchaser, financing entity, special purpose entity or related provider trust;

(4) A natural person who enters into or effectuates no more than one agreement in a calendar year for the transfer of life insurance policies for any value less than the expected death benefit;

(5) A financing entity;

(6) A special purpose entity;

(7) A related provider trust; or

(8) A viatical settlement purchaser.

(9) An accredited investor or qualified institutional buyer as defined respectively in Regulation D, Rule 501 or Rule 144A of the Federal Securities Act of 1933, as amended, and who purchases a viaticated policy from a viatical settlement provider.

The Process

The process typically begins with an application that is submitted to a broker or to a Life Settlement company directly. Brokers offer the service of obtaining several bids from several providers in exchange for a fee. Some sellers prefer to deal directly with providers and save on broker commissions.

Once the application is received by the provider, the case is reviewed by an underwriting team. If the life policy meets certain criteria, it will be approved for purchase. The Life Settlement Company then submits an offer to the policy owner. If accepted, closing documents are sent to the policy owner. Once such documents are executed and received by the Life Settlement Company, the purchase price funds are placed in escrow at a financial institution as required by applicable laws. After the appropriate change of ownership/beneficiary forms are received by the escrow agent, the funds are released to the policy owner.

Depending on the availability of the documents, the entire transaction takes about 6 to 8 weeks. Finally, once the transaction is consummated, the purchaser (i.e. the Life Settlement provider) becomes the new policy owner, premium payer, and beneficiary of the death benefit.

Due Diligence by an advisor regarding Life Settlements

Most of the readers of this material will be acting in a fiduciary role when helping a client review and decide to sell a life insurance policy to a life settlement company. As an adviser, you should approach this responsibility using the following process:

- First it must be determined if the client is in the correct financial situation to even consider a Life Settlement.

-Is a Life Settlement or a 1035 exchange more appropriate?

-Perform an analysis on the policy in question as to its current and likely future performance.

-Perform due diligence by examining the marketplace to find reputable Life Settlement providers/brokers backed by solid institutional funding.

-Obtain the highest market value for the policy owner by insisting on multiple offers from the brokers or from several Life Settlement providers.

Tax considerations

Unlike viatical settlements, the proceeds from a Life Settlement may be taxable depending on the cost basis of the policy, the cash surrender value and the amount received from the Life Settlement. If the settlement amount is less than the cost basis, there should not be a tax liability.

The tax treatment to the owner who sells a life insurance policy will depend upon whether it is considered a "viatical settlement" (i.e. where the insured is terminally or chronically ill) or a "Life Settlement" (i.e. where the policy owner is not terminally or chronically ill).

Generally speaking, viatical settlements offer more favorable tax treatment than Life Settlements. Under IRC Code Section 101(g), amounts received from the sale or assignment of a life insurance policy where the insured has a terminal illness or a chronic illness to a qualified viatical settlement provider will be excluded from gross income as an amount paid by reason of death of the insured. Therefore, if the sale is considered a v*iatical settlement* under the 1996 Federal HIPAA rules, terminally or chronically ill individuals who sell their life insurance contracts will not have to pay federal income taxes on the income they receive from that sale. Many states also have made v*iatical settlements* free of income taxes.

As virtually all Life Settlements do not involve insureds with terminal illnesses or chronic illnesses, such tax advantages will not be available to sellers of Life Settlements and the sale may be subject to federal income tax. The proceeds from a Life Settlement are tax free up to the amount invested into the policy (i.e. premiums paid less any dividends or loans received by the owner). Any monies received in excess of the amount invested and up to the cash surrender value is considered profit and may be taxed as ordinary income. Proceeds in excess of cash surrender value are considered to be capital gains, depending upon the particular situation.

TAXATION DIAGRAM

This chart explains the three tier system

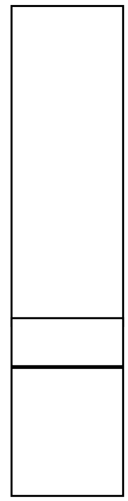
Assume a $1,000,000 Policy issued 10 years ago and

$400,000 Settlement Amount Paid to Policy Owner

$225,000
Taxed as
Long Term
Capital Gain

$25,000
Taxed as
Ordinary Income

$175,000 CSV (Tax Basis Plus Earnings)
$150,000 Tax Basis (i.e. premiums paid)



NAIC Disclosures

When a policyholder decides to enter into a Life Settlement transaction, the provider company will provide the policyholder with certain disclosures similar to those prescribed by the NAIC. As an adviser, you should be familiar with these types of disclosures and advise your client according to the specific circumstances. The disclosures, generally, include the following:

-There are possible alternatives to viatical settlement contracts including any accelerated death benefits or policy loans offered under the viator's life insurance policy.

-Some or all of the proceeds of the viatical settlement may be taxable under federal income tax and state franchise and income taxes, and assistance should be sought from a professional tax advisor.

-Proceeds of the viatical settlement could be subject to the claims of creditors.

-Receipt of the proceeds of a viatical settlement may adversely affect the viator's eligibility for Medicaid or other government benefits or entitlements, and advice should be obtained from the appropriate government agencies.

-Entering into a viatical settlement contract may cause other rights or benefits, including conversion rights and waiver of premium benefits that may exist under the policy or certificate, to be forfeited by the viator. Assistance should be sought from a financial adviser.

Other requirements NAIC prescribed disclosures include:

-A viatical settlement broker shall disclose to a prospective viator the amount and method of calculating the broker's compensation. The term "compensation" includes anything of value paid or given to a viatical settlement broker for the sale of a policy.

-If an insurance policy to be viaticated has been issued as a joint policy or involves family riders or any coverage of a life other than the insured under the policy to be viaticated, the viator shall be informed of the possible loss of coverage on the other lives under the policy and shall be advised to consult with his or her insurance producer or the insurer issuing the policy for advice on the proposed viatical settlement.

-State the dollar amount of the current death benefit payable to the viatical settlement provider under the policy or certificate. If known, the viatical settlement provider shall also disclose the availability of any additional guaranteed insurance benefits, the dollar amount of any accidental death and dismemberment benefits under the policy or certificate and the viatical settlement provider's interest in those benefits.

What if a client changes his/her mind after selling a life policy?

It depends on the state, but as a general rule, a client can cancel the life settlement up to the 15th day after the client receives the money. In some states the date can be extended to 30 days.

If the client changes his/her mind, the life insurance policy ownership which previously was transferred to the life settlement company must be transferred back to the client. The specifics of rescinding a life settlement sale will be described in the purchase and sales agreement signed by the client (and that document should mirror state law).

What if a client dies shortly after completing a life settlement sale?

Again, this will vary per state statute, but as a typical rule, the contract for sale will be automatically cancelled if the insured dies within 15 days of having received the purchase price for the policy. The Provider (life policy purchasing company) will typically receive the death benefit and will be required to pay the entire death benefit to the beneficiaries designated in the life settlement contract minus the amount of money previously paid to the deceased client via the life settlement payment as well as any premiums the life settlement company paid (if any) to keep the policy in force prior to the client's death.

What does the Provider do with the client's information provided prior to sale of the life policy?

The financial, medical or personal information given to the Provider shall be kept on record and not be shared with anyone else unless the client has given written approval that the information may be shared. If the client signs a written approval sharing the information, that document must list who exactly may view that information and why it would be released. Strict federal and state privacy laws apply to the release of client financial and medical information.

Will a Provider contact clients about their health status?

A Provider does have the right to contact the client (viator) to determine the client's health status. The Provider has a vested interest in the health of the client and the health of the client could affect the way a Provider deals with the finances of the newly purchased life policy.

If a client does not want to be contacted about his/her health status, the client may appoint an adult person to be contacted on the client's behalf. This person must be in regular contact with the client and must give the provider their name, phone number and address. Generally, once an intermediary is appointed the Provider is not supposed to contact the client directly unless the Provider cannot contact the intermediary for more than 30 days.

The Provider is also supposed to give to the client the name, address and phone number of the person who will be contacting the client to discuss his/her health status. If the client's life is expected to end within one year, contacts by the Provider to check on the health of the client are supposed to be limited to once every 30 days. If the client is not supposed to die within one year, contact by the Provider is supposed to be limited to once every 90 days.

Some Providers will request that clients sign a release form allowing the Provider to contact the client's physician(s) to get updates on the client's health status. The client has the right to withdraw this consent, which is dictated by state law.

Examples of Life Settlements

Let's look at a real world example and see if it makes sense for our mythical client Dr. Smith to consider selling his life insurance policy.

> Facts: Dr. Smith is a 65-year-old retired orthopedic surgeon who is married to a 65-year-old retired nurse. Dr. and Mrs. Smith have three children and six grandchildren. Their assets consist of a home worth $1,000,000 that is paid off, a $2,000,000 brokerage account, a $1,500,000 IRA, a vacation condo in Naples worth $350,000, and a universal life insurance (UL) policy on Dr. Smith with a $2,000,000 death benefit and a cash surrender value of $75,000. Dr. Smith's total taxable estate for estate tax purposes is: **$6.85 million dollars**.
>
> Assume that the life insurance policy is **not** in an irrevocable life insurance trust (ILIT, which you can read about on page 121); and, therefore, if Dr. and Mrs. Smith died in a car crash tomorrow, their heirs would be left with approximately $4,125,000 of that $6.85 million dollars after income and estate taxes. This assumes Dr. and Mrs. Smith had, as a minimum, A&B living revocable trusts to maximize their estate tax exemptions. If the Smiths did not use their estate tax exemptions properly at death, they would pass to their heirs, after all taxes, $3,625,000.
>
> Facts about Dr. Smith's current UL policy:

Dr. Smith purchased the UL policy at age 55 for estate planning/investment purposes where the annual premium was and still is $20,000 a year. The UL policy has $75,000 in cash surrender value and a $2,000,000 death benefit.

If the Smiths could rewind the clock prior to their death (assuming they died together in a car crash), they would have certainly figured out a way to get that $2,000,000 death benefit policy into an ILIT so the entire death benefit could pass income and estate tax free to the heirs. This blunder in their estate plan cost their heirs $1,000,000 (half of the death benefit at the 50% estate tax rate).

Again, why would someone sell their life insurance policy for cash?

In our example, what would the Smiths be able to sell their $2,000,000 policy for? An educated guess based on the current life settlement market would be $345,000.

Tax consequences.

The amount of premiums paid into the policy is its “basis,” and no tax is due on that value. The cash surrender value in the policy is taxable as ordinary income, and the life settlement payment which accounts for the remainder of the sale price (if any) receives capital gains tax treatment.

In our example, Dr. Smith paid $20,000 a year for 10 years, which would give him a basis of $200,000. The cash surrender value is $75,000. If you add the two, you get $275,000; and the remaining $70,000 would be taxed at the capital gains rate.

Outcome:

No tax on the $200,000 basis.

$75,000 taxed at 40% (worst case scenario) leaves $45,000 after tax.

$70,000 taxed at 20% capital gains leaves $56,000.

Total in pocket for the Smiths after tax = $301,000.

Getting back to the example—if Dr. Smith and his wife were healthy, Dr. Smith could sell his UL policy and have in pocket $301,000 (net). The Smiths could then purchase a $2,000,000 second-to-die life insurance **policy owned by an ILIT** where the death benefit will pass income and estate tax free to their heirs.

The premium for the Smiths’ new second-to-die $2,000,000 policy would be $25,000 a year until death. Remember that Dr. Smith is currently paying $20,000 a year for his current UL policy; and, therefore, he would only have to pay an additional $5,000 a year to purchase the second-to-die policy that would be owned by the ILIT.

Let’s finally assume that Dr. Smith and Mrs. Smith die together in a car crash in Naples, Florida, where they were retired at their ages of 85. How did the Smith family heirs benefit from the above example?

1) The $2,000,000 second-to-die life policy would pass to the heirs income and estate tax free therefore saving the heirs $500,000 in estate taxes.

2) The additional cost of the life insurance policy per year was $5,000 and that was paid for 20 years until the Smiths’ turn age 85. If we subtract that $100,000 extra premium from the $301,000 net payment from the life

settlement, the heirs received an additional $201,000 (assuming **no growth** on that money for 20 years).

Total additional money for the heirs = $701,000.

Again, why should a physician consider selling his/her current in-force life insurance policy? Because in some circumstances that sale will have a significant positive financial impact on the physician and his/her heirs.

Another example of the benefits of a Life Settlement

What if a life insurance policy is purchased and the reason the life insurance policy was purchased no longer exists. When might this situation arise?

1) If Dr. Smith bought a life policy to take care of his spouse should Dr. Smith die first, but instead of Dr. Smith dying first, Mrs. Smith died first. Since the policy was for the benefit of Mrs. Smith, there might no longer be a need for the policy. The same would be true if the life policy was purchased for Mrs. Smith and, instead of dying, she divorced Dr. Smith.

2) If Dr. and Mrs. Smith wanted to pass wealth to their heirs (children) and then the children turn out to be heroin addicts or otherwise become estranged from the family. In this situation, the Smiths might decide to cut the children out of the will altogether or, at the very least, simply do not want a large death benefit to pass to the undeserving children.

In situation one above, there is NO reason for Dr. Smith to continue to pay on a universal, variable, or whole life insurance policy. Mrs. Smith is dead or divorced (the first situation is sad, and the second is expensive), but the bottom line is the need for the death benefit is gone. Therefore, a Life Settlement for Dr. Smith would make a lot of sense so he could stop paying premiums and pocket some cash to do with what he wanted. I suggest in the divorce situation that Dr. Smith wait until the divorce is finalized before cashing in the policy.

In situation two above, while the children are not dead, they are not deserving of the death benefit; and, again, there is no incentive to continue to pay the premiums. Therefore, finding a situation where the Smiths can stop paying and recoup all of their premiums and more is an attractive option.

More Examples

Term Conversion

Dr. Smith's 20-year term policy was reaching its conversion deadline. He is now 79 and was recently diagnosed with coronary artery disease. Dr. Smith cannot afford to convert the policy and letting his $250,000 policy lapse would leave him nothing.

Dr. Smith applied to a Life Settlement company and his policy was sold for $75,000. Dr. Smith was able to recover all of the premiums he had paid into the policy, plus a nice profit. Dr. Smith could then use the money to pay bills, go play golf on vacation, or put money away for later in retirement.

Unplanned Health Change

Roger was 76 and had just suffered a stroke, which left him permanently disabled. His family was unprepared for this. After learning of the Medicaid requirements and the cost of a care facility, the family was unsure how they were going to pay for his care.

Fortunately, his CWPP™ advisor suggested that Roger look into a Life Settlement when it was learned that he owned a $500,000 life insurance policy. Roger decided to sell the policy for a $250,000 settlement, and eliminated the future premium payments on that policy. These funds covered the three years Roger lived in a nursing home facility before dying. The remaining cash was distributed to Roger’s original beneficiaries.

Additional Insurance Needed

An elderly couple had a $2.2 million policy held in an insurance trust that covered the wife. Due to good investments, their estate had increased quite a bit and now the death benefit on the policy was inadequate to cover the couples’ growing estate tax problems.

Their CWPP™ suggested that the clients sell the life policy to help fund the purchase of a new $4 million dollar joint survivorship policy. A qualified Life Settlement broker was able to negotiate a $450,000 purchase price. Since the husband was in perfect health, the premiums on the survivorship policy were very affordable and were actually less than the policy sold.

Key-Man

A company owns a $5 million dollar policy on an older executive who had retired 3 years earlier. The surrender value was $600,000 and since the company no longer wished to make the $90,000 per year premium payments, the company was considering surrendering the policy for its cash surrender value (CSV).

Their CWPP™, when learning of the situation, suggested that the client consider a Life Settlement. The company was offered $1,000,000 for the sale of the policy and netted $950,000 after taxes, almost doubling the cash surrender value. The tax calculations are omitted since the case is a mythical case and for brevity purposes.

Life Settlements without a Broker

As discussed earlier, typically, when a client decides to sell his/her life insurance policy to a settlement company, there is a "broker" invovled. The broker takes the application from an advisor who has the direct relationship with the client and then shops the life policy with a handful of companies that specialize in purchasing life polices.

Advisors see the broker as a vital part to the sale of a life settlement to a client because advisors do not have direct relationships with the companies that actually purchase the policies.

If an advisor could create or find a direct relationship with a life settlement company, the broker could be cut out of the picture and the client and the advisor would benefit.

As a general rule, the broker can negotiate with a life settlement company a "commission" of approximately 6% of the death benefit of the policy purchased. As an example, if the client's life insurance policy has a death benefit of $1,000,000, the commission on the table for the broker is $60,000. Brokers typically do not disclose this number to the advisor and instead tell the advisor approximately how much the advisor will make on each case.

Brokers can take up to 50% of the available commission. If the broker can be cut out, the client can receive more money from the settlement company and the advisor who is really doing the majority of the work can also increase his/her commission.

There are life settlement companies that will help work directly with advisors and without brokers so the client and the advisor would be better off from a financial point of view.

Summary of Life Settlements

While the topic of Life Settlements is not in the mainstream, it has enough application for the readers to be aware that the concept exists and is avaible option for certain clients.

I know that many clients have had changes in their lives that could make a Life Settlement advisable. Now that you know what they are and how they work, hopefully, if you ever have a client who would benefit from a Life Settlement, you'll be able to bring up the topic.

Viatical Settlements

What are viatical settlements?

A viatical settlement is also known as a life settlement and is the sale of the benefits of a life insurance policy to a third party. Viatical Settlements differ from the previously discussed Life Settlements in that the life insurance policies are purchased directly from ill people, using either private funds or money received through the sale of company stock.

These companies themselves hold all the rights to the insurance policy and act as the designated beneficiary of the policy. The viatical settlement industry deems these transactions "non-brokered" because the viatical settlement provider purchases the policies directly. Investors participate by being stockholders in the viatical settlement company.

Why would a terminally ill client sell their life insurance policy?

When the typical person thinks about a terminally ill client selling their life insurance policy, they think that the beneficiaries are going to be upset and will end up on the short end of the stick financially.

However, after the following reasons are brought to light, you will see that the sale of a life policy by a terminally ill client can make a lot of sense.

-To cover the costs of medical care that insurance does not, such as experimental drugs or treatment that could not otherwise be afforded;

-Viatical Settlements can provide the extras that make life more meaningful, such as a family trip. Many families might find more value in one last family trip with the soon to be deceased family member than the death benefit that will come to the beneficiaries;

-Viatical Settlements can protect a client from losing valuable assets, including a home or other investments. Many clients prior to passing away will be in dire financial straights due to lost income. For those clients, cash is needed to keep family possessions and therefore a Viatical Settlement is a needed tool.

How does a typical Viatical Settlement work?

Let's assume an investor wants their money tied up for two years. Viatical settlement brokers rarely keep a portfolio of viatical settlement contracts, but instead go out and find policies that meet the requirements of the investors. The viatical company pools the investor's funds with the funds of other investors to purchase a policy of a viator who is expected to live for only 24 months.

The viatical company uses investor funds to purchase the policy. The viatical company is then named as the beneficiary on the policy, not the investors. The viatical company will track the names of the investors and their pro rata share of the policy proceeds. Investors in brokered arrangements have an equitable interest in the policy, but are not listed as beneficiaries on the policy.

Once the viatical company has purchased a policy, the investor should receive some sort of notice that indicates the investor's ownership interest in the policy. The investor should also receive some minimal information about the viator, but laws regarding the confidentiality of health and medical records prohibit the disclosure of personal information. Finally, the investor should receive periodic updates of this information, but many companies provide such updates only annually.

The viatical company sets aside enough money from the initial investment from investors to pay the insurance premiums for the period that the viator is expected to live plus an additional period. In our example, the company would have collected sufficient funds to pay premiums for two years.

Because it is impossible to predict how long a person will live, even someone with a terminal illness, the viatical company is expected to also maintain a reserve fund that can pay premiums for another period of time beyond the original projection. Here, with a contract of 24 months, most viatical companies maintain a reserve of at least six months.

If the viator dies within the projected time period, the viatical company files a claim with the insurance company and distributes the proceeds of the policy to investors on a pro rata basis. If the viator does not die within the projected time, the premium on the policy must continue to be paid so that the policy will not be canceled.

Are the investment returns of Viatical Settlements Guaranteed?

Viatical companies frequently try to convince investors that an investment in a viatical is "guaranteed" because everybody dies. But that is not the proper way to measure the worth of any investment, even a viatical settlement. What is not guaranteed is the date of death of the insured person (viator). The rate of return on a viatical settlement is completely dependent on when the viator dies. At a minimum, the investor should expect to have the principal returned with the additional amount promised by the viatical company, but that is hardly the same as saying that the return is guaranteed as of the projected date.

The viatical salesperson will ask how long a client wants to invest. The decision determines the amount of return on the investment, but not the rate of return. For example, let's say a client wants to invest $10,000 for two years. The company tells client that the return will be $2,280, for an annualized rate of return of 11.4 percent per year. However, if the viator dies in four years, instead of two, the annualized rate of return drops to 5.5 percent. The longer the viator lives, the lower the annualized rate of return.

However, that is not the worst case scenario. It is possible that the return could be negative if the reserve fund set aside to continue to pay policy premiums is depleted before the viator dies. Investors could be the ones left to continue making premium payments without which the policy would terminate. If that premium were unpaid, the policy would be canceled and the investor(s) would lose their entire investment.

In that instance, an investor also needs to remember that just because they may want to continue making premium payments does not mean all of the other investors will wish to do so. An investor could still lose their investment if the other investors with whom they were pooled to purchase the policy now fail to make their pro rata premium payments for the next period. In that case, the remaining investors could be offered the right to assume the interest of one or more of those other investors. If that were to happen, each investor who decided to continue to make premium payments would have to increase their pro rata share of the policy proceeds.

Are viatical settlement investments appropriate for the small investor?

Viatical settlement investments should only be made to suitable investors or other persons that the viatical issuer reasonably believes, after inquiry, to be suitable investors. A good definition of a suitable investor would include:

> -A natural person who, either individually or jointly with the person's spouse, (1) has a minimum net worth of one hundred fifty thousand dollars ($150,000) and had, during the immediately preceding tax year, gross income in excess of one hundred thousand dollars ($100,000) and reasonably expects gross income in excess of one hundred thousand dollars ($100,000) during the current tax year, or (2) has a minimum liquid net worth of two hundred fifty thousand dollars ($250,000). "Net worth" shall be determined exclusive of home, home furnishings, automobiles, and assets employed in a trade or business. Other assets included in the computation of net worth shall be valued at fair market value. The aggregate amount of viatical investments of each natural person shall not exceed 10 percent of their net worth, as defined above.

It is important to emphasize that viatical settlement investments are rarely, if ever, appropriate for seniors or others on a fixed income. They are also inappropriate for individuals as a first investment or as the only investment a person has.

Isn't investing in viatical settlements a humanitarian thing to do?

As part of their sales presentation, a viatical company may try to convince investors that their investment serves an important, humanitarian purpose. They say that the investment enables terminally ill patients to live the last part of their lives with the money to afford greater comfort and dignity. The patient needs the money while they are still alive, rather than merely paying a benefit to someone after they are dead. Also viatical settlements guarantee the payment of life insurance premiums when terminally ill people are most likely to stop payment - when they are too ill to work and cannot continue paying their life insurance premiums.

This argument plays on human compassion and the interest in having a "win-win" arrangement that the investor can feel good about. However, the realities of the viatical investment market reduce some of this appeal.

Didn't *60 Minutes* report that viaticals are the "perfect no-risk investment"?

Some promotional materials from viatical companies still use this out-of-context quote from a *60 Minutes* program broadcast in 1995. Program host Morley Safer actually said:

> "And, sadly, the deadliness of AIDS makes (viatical settlements) a perfect no-risk investment: quick profits guaranteed in the death futures market with enough buyers available for an AIDS patient to shop around. Value is graded on the bleakness of medical charts."

But as outlined in Kiplinger's Retirement Report (Dec. 1998), this show aired before the death rates of those infected with HIV began declining dramatically because of new drug treatments. The prognosis for patients with AIDS and HIV is far different today than it was five to eight years ago. And guessing when someone will die is never a sure thing.

There is no such thing as a "no-risk" investment and not every investment is a good match for every investor. Viaticals are definitely risky and may not be "perfect" for many investors.

What happens if the underlying policy was obtained based on misrepresentations of health status?

If a life insurance policy was obtained through fraud, the insurance company has two years to discover that fact. This is called the contestability period. If the company discovers the fraud, the company can cancel the policy. Investors who contemplate purchasing a viatical investment should be sure that the policies that are sold as investments are all beyond the contestability period.

It is very difficult to determine if a viatical investment is legitimate. There is no easy way to know whether the underlying insurance policy was obtained without fraud, or to know whether the viatical company and the escrow agent/trustee will be around until the death of the insured. Be sure that the viatical seller gives you a prospectus and that the offering is registered with the Division of Finance and Corporate Securities. And make certain that all of your questions are answered by the seller.

What questions should be asked to the person trying to sell a viatical settlement?

-Have these securities been registered with the Division of Finance and Corporate Securities of the appropriate State? Do not believe any seller who tells you that viaticals are not subject to the securities laws.

-Is the salesperson a licensed broker/dealer? If not, is the salesperson exempt from licensing?

-Who are these sellers and how long have they been in business?

-Where is the business located?

-Who are the principals in the business?

-Have there ever been any complaints filed against the company or the principals with either state or federal securities regulators or lawsuits filed by other investors?

-Is a prospectus about the investment available from the company before you invest? If not, why?

-Be certain that the insurance policy being invested in is outside the two-year contestability period. Contestable policies carry special risks.

-Will this investor be an owner of the policy or simply a beneficiary? Being a beneficiary but not an owner carries special risks.

-Ask if the policy being purchased is a group policy. Group policies carry special risks.

-Be careful about investing money from an IRA in a viatical contract. If the funds from the viatical are not available to the investor by age 70 ½ and there are not sufficient funds left for the mandatory distribution, he/she could be penalized by the IRS.

-Be certain that all of the details about the policy and the seller's promises, guarantees and claims about the viatical and the underlying life insurance policy are in writing.

Viatical sale example:

Assume you have an AIDS patient (John Smith) who has been told "for certain" that he is going to die within 12 months. Patient Smith, for whatever reason, decides that he would like to enjoy his last 12 months of life by traveling around the country with his family. The problem is that he does not have a lot of money but does have a million-dollar life insurance policy that will pay at his death. Patient Smith finds a willing buyer and sells his future death benefit (his life insurance policy) for, let's say, $500,000 cash.

Patient Smith travels around the country with his family and then dies twelve months after his life insurance policy was sold. Patient Smith got what he wanted (instant cash), and the buyer of the life policy got what he/she wanted, which was $1,000,000 income tax free when Patient Smith dies or $500,000 more than his investment (minus fees).

HIPPA

On September 5, 1996, President Clinton signed the Health Insurance Portability and Accountability Act (which caused health insurance costs to soar for the small employer). One of the few decent changes that came out of HIPPA was a provision that allowed people diagnosed with a terminal illness to sell their life insurance policies to viatical settlement companies for a tax free, lump sum payment.

What can go wrong?

1) *Technology.* Can you imagine buying the life insurance policy of a terminally ill AIDS patient just prior to the time when all the new AIDS drugs hit the market? Suddenly, some AIDS patients who were supposed to die within 12 months now are able to live for years longer than predicted. That is great for the patient and society but bad for the viatical investor.

2) *Poor diagnosis*. This is one reason VS should be a good fit for physicians. Getting a correct diagnosis with a VS is absolutely imperative. If a physician incorrectly designates someone as terminal and they live for years, the viatical investor has a significant problem. While not all physicians are experts in terminal illnesses, all physicians did go to medical school and all have friends they can call to help review medical records of a patient trying to sell their life insurance policy.

3) *Act of God.* There is nothing that can be done in this case, and the investor (if they believe in God) will just have to take the chance that a miracle will not happen.

Conclusion on Life Settlements and Viaticals

Life Settlements, in their newer form, revolve around helping clients with viable in force life policies sell those policies for a variety of reasons. Those reasons range from the fact that the need for the life policy no longer exists, the client cannot afford the premium, the client would like to transition into a better and more financially viable policy or the client simply would like more money from a life settlement to spend as he sees fits for recreational purposes.

The bottom line with Life Settlements is that advisors can use the tool to help clients receive more money from the Life Settlement rather than "surrendering" the policy. Due to the fact that few clients know Life Settlements exists, advisors who do know about them can use them to not only help clients, but also differentiate themselves from other advisors in a local area. Finally, as the topic becomes more known, it is this author's opinion that it should be explored with clients with life policies in force who are over the age of 65 so as to avoid a potential violation of fiduciary duties to do what is in the best interest of the client.

Viatical Settlements are a completely different topic and are seen by clients as a quick way to double their money through an interesting investment. The Viatical community is full of fraud and the concept in general is full of uncertainty. The topic of Viatical sales as an investment is not covered in this material to let advisors know how wonderful of an investment it is, but instead to teach readers technically how they work and to be cautious when reviewing them for a client.

Licensing Requirements Chart

STATE	States with Life Settlement Laws	States with Viatical Settlement Laws	States without Life or Viatical Regulation
Alabama			X
Alaska	X	X	
Arizona			X
Arkansas	X	X	
California		X	
Colorado			X
Connecticut	X	X	
Delaware		X	
District of Columbia			X
Florida	X	X	

Georgia			X
Hawaii			X
Idaho			X
Illinois		X	
Indiana		X	
Iowa	X	X	
Kansas	X	X	
Kentucky	X	X	
Louisiana	X	X	
Maine	X	X	
Maryland	X	X	
Massachusetts		X	
Michigan		X	
Minnesota		X	
Mississippi	X	X	
Missouri			X
Montana	X	X	
Nebraska	X	X	
Nevada	X	X	
New Hampshire			X
New Jersey		X	
New Mexico		X	
New York		X	
North Carolina	X	X	
North Dakota	X	X	
Ohio	X	X	
Oklahoma	X	X	
Oregon		X	
Pennsylvania	X	X	
Rhode Island			X
South Carolina			X
South Dakota			X
Tennessee	X	X	
Texas	X	X	
Utah	X	X	
Vermont		X	
Virginia	X	X	
Washington		X	
West Virginia			X
Wisconsin		X	
Wyoming			X

States with
Viatical Settlement

States with neither Viatical
or Life Settlement Laws

States with both
Viatical and Life