Life Settlements

Why You Should Consider Selling Your Life Insurance Policy

The concept behind Life Settlements (hereinafter LS) is fairly simple. LSs are for someone who purchased a life insurance policy, 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.

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

A LS, as the name infers, is the sale of an existing life insurance policy of a client who is intending on living but has no current use for the particular life insurance policy he/she is thinking of selling.

Why sell a life insurance policy?

We think a better question is why keep a life insurance policy you have no need for. That question brings us to the age old question of why and when should someone buy a life insurance policy. We discuss at length starting on page 116 why someone would purchase a life insurance policy and, specifically, which type of policy to purchase. There are two main reasons people 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 clients will **not** implement proper estate planning; and, therefore, the cure-all is to purchase life insurance to pay for estate taxes (assuming the clients and spouse do not both die in 2010 when there is no estate tax).

Let's look at a real world example and see if it makes sense for 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 127); and, therefore, if Dr. and Mrs. Smith died in a car crash tomorrow, their heirs would be left with approximately $4,375,000 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 (we are 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 55% estate tax rate in 2011 and beyond).

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.

Side Note: Tax consequences of selling a life policy.

> 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 client 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 insured and his/her heirs.

Another example for 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 get in his pocket cash to do with what he wanted. We 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 premiums and recoup all of their premiums and more is an attractive option.

Summary of Life Settlements

While the topic of Life Settlements is not in the main stream, it is becoming much more common. We not only wanted to make sure readers knew the concept exists, but we wanted to give quite a bit of detail. While the topic might not be too useful for a younger reader, it might apply to a younger reader's parents or older friends.

We know that many clients have had changes in their lives that could give rise to a situation where a Life Settlement would make sense. Now that you know what they are and how they work, hopefully, if you ever have a need to look at the Life Settlement concept, you'll remember reading this material.

If you or one of your parents could benefit by using a Life Settlement and would like more information or an illustration as to how much you could sell your life insurance for, please contact our firm.