

INSURANCE

A life settlement can be a better alternative than surrendering a policy.

Turn Unneeded Policies Into Cash

BY JAMES D. WARRING

EXECUTIVE SUMMARY

- **WHEN INDIVIDUALS OR BUSINESSES HAVE UNNEEDED** life insurance policies they have three options: continue paying the premiums until the insured's death, surrender the policy for the cash value or find a third party to buy the policy in a life settlement transaction. The last alternative usually is the most attractive if the insured is over 65, has experienced a change in health and has a life expectancy of 2 to 12 years.
- **LIFE SETTLEMENT TRANSACTIONS USUALLY** result in higher returns for the policy owner than simply surrendering the policy. The actual settlement depends on the policy's face amount and cash surrender value, the insured's health and age and the current policy premium.
- **THE FIRST STEP IS TO SELECT A BROKER TO HELP** get the best possible offers for the policy. The broker will help choose an appropriate provider. An institutionally owned and funded provider usually has more cash available

to invest in policies and will adhere to high ethical standards.

■ **A VARIETY OF SITUATIONS CAN CREATE THE NEED** for a life settlement, including a change in the policyholder's business situation, a need for cash to fund medical or long-term care, changes in the insured's estate, bankruptcy or divorce.

■ **LIFE SETTLEMENT TRANSACTIONS MAY BE SUBJECT** to income taxes. The actual amount of taxable income depends on the policy's cash surrender value, cost basis (total premiums paid) and how much the policy owner receives for the policy. Some of the proceeds may be ordinary income and some may be treated as a capital gain.

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Life insurance planning isn't always about making sure someone has enough coverage. It's also about finding solutions for people who have too much. For them, it's a question of whether it's better to continue paying premiums in hopes of a gain at maturity or recoup some of that investment immediately by surrendering the policy. High premiums often put policy owners in a difficult position—especially if their insurance needs have changed. Corporate policy owners face similar concerns when dealing with key-person or split-dollar policies insuring departed executives or with insurance purchased to fund an obsolete buy-sell agreement.

In some instances the best alternative is neither to hold the policy nor to surrender it. This article explains how CPAs can use a third option—a life settlement—to help eligible clients and employers dispose of unneeded life insurance policies now for more than the cash value rather than wait for the policy to pay off at the insured's death.

Life Settlement Facts

■ **Seniors own an estimated \$500 billion in life insurance policies.**

■Some \$100 billion of these policies are eligible for life settlements.

■Life settlement providers will purchase \$10 billion to \$15 billion of insurance policies in 2005.

Source: "2005 Life Settlement Industry Outlook"

LIFE SETTLEMENTS—WHAT THEY ARE AND AREN'T

A life settlement turns insurance assets into cash, giving the original policyholder an amount greater than the cash surrender value in exchange for ownership of the policy. This option creates immediate revenue for companies or individuals holding unprofitable or unneeded policies.

Life settlements are not viatical settlements, which terminally ill policyholders often use to raise quick cash. Rather, the typical life settlement candidate has a life expectancy of between 2 and 12 years. The best prospects for such transactions are age 65 or older, have experienced a change in their health and are insured by a policy with a face amount of at least \$100,000.

When an individual or business engages in a life settlement transaction, the amount it recoups is based on the policy's face amount and cash surrender value as well as other factors, such as the insured's health, age and the current policy premium.

In a recent survey of accountants, attorneys, estate planners and insurance professionals, 45% of respondents had clients over age 65 that had surrendered a life insurance policy for its cash value. Many instead could have qualified for a larger cash payment from a life settlement. Considering that cash surrender values average just 4% of policy face amounts, the decision to recommend a life settlement is an easy one for CPAs advising employers or clients unaware of the potential economic gain from these hidden assets.

When providing financial advice and strategic information to clients or employers, CPAs have a fiduciary responsibility to identify effective ways to eliminate assets that burden the client or employer with unnecessary expenses. For CPAs in public practice, marketing and promoting life settlements can be easy; many accountants have clients that fit the life settlement eligibility profile. Any number of situations can create the need for a settlement, including

- A change in interest rates that results in increased policy premiums.
- A change in a policyholder's business situation.
- A need for cash to fund medical or long-term care.
- Improved estate liquidity, a decrease in estate value or elimination of the federal estate tax, making an existing policy unnecessary.
- Bankruptcy.
- Divorce.
- Departing executives or business owners, making policies redundant.

STEP-BY-STEP

To start the process, select a professional life settlement broker to help get the best possible offers for the policy you wish to dispose of. Look for one with experience in the field and connections to major settlement providers. [Exhibit 1](#), below, lists some questions CPAs should ask a broker in choosing one to represent a client or employer in a life settlement transaction.

Exhibit 1: Choosing a Broker

- How many life settlement providers does the broker represent, and does it submit all cases to each provider? (If not, this may be a warning that there is an unfair agreement with a favored provider the broker has not disclosed that could be detrimental to the client.)
- Does the broker have due diligence materials for each of its life settlement providers, and will it provide the CPA with a summary of this material?
- Does the broker represent any private funding sources? If so, will it honor your instructions not to shop your policies to private sources (which we recommend avoiding)?
- How many life settlement transactions did the broker successfully fund in the last 12 months?
- What commission will the broker earn from the provider when a transaction is successfully completed?
- Is the broker licensed to do business in the necessary states to complete the transaction, and does it have errors & omissions coverage specifically for life settlement transactions?

It's important to select a broker who represents institutionally owned and funded settlement providers. These entities typically

organization of private investors. An institutionally owned and funded provider usually has more cash available to invest in policies and will adhere to high ethical standards to protect both consumers and the entity's broader business interests. They also hold purchased policies in confidential portfolios. Most institutional funders are members of the Life Settlement Institute, a national trade association that represents institutionally funded companies.