accountingTODAY

Voices How a life settlement can help a client during a pandemic

By Henry Montag, Steve Shorrock

The life settlement market evolved in the late 1980s with the AIDS outbreak, when terminally ill individuals were liquidating assets to generate cash. Given the sellers' shortened life expectancy, investors were purchasing their life insurance policies for an amount in excess of the policy's cash value and expecting a return from payment of the death benefit. Subsequently, the market became highly regulated and expanded to include older as well as impaired-risk insured persons.

Legal and tax advisors play a critical role in alerting their clients to the availability of the secondary market, particularly during the COVID-19 pandemic when many people are looking for sources of cash and can no longer afford their insurance premiums. The lapsing policy and insurance trust insolvency crisis begs the obvious question from legal and tax advisors — what do you do when an older client inquires about the possibility of restructuring or selling an existing problematic policy?

The market

Tens of thousands of Americans annually lapse or surrender their life insurance policies to insurance companies. Americans ages 65 and older forfeit $143 billion dollars of life insurance coverage annually by lapsing or surrendering their life insurance policies, according to research unveiled at the Life Insurance Settlement Association's Fifth Annual Institutional Investor Life Settlement conference (latest figures as of 2015).

A survey of seniors conducted by ICR Custom Market Research found that 55 percent of respondents allowed their life insurance policies to lapse; and further, 82 percent were not aware that alternatives like a life settlement existed. In that same study 79 percent of clients felt advisors should inform them about a life settlement strategy. A study conducted by the Insurance Studies Institute found that 90 percent of seniors who lapsed a life insurance policy would have considered a life settlement had they been aware of the possibility.

The problem

The problem is the majority of clients, and many of their advisors, are not familiar with the concept of a life settlement. If a decision is made to no longer maintain their coverage, most clients either surrender the policy back to the life insurance company for its cash surrender value, or they merely stop paying the billed premium and, by virtue of default, they use up the accumulated cash surrender value until the coverage expires.

One of the major reasons for this lack of knowledge involves a profit motive for the insurance companies, as they would prefer that a person, regardless of their reason for not continuing their coverage, either surrender their policy back to the insurer, or merely discontinue paying their billed premium, as either option translates into the insurance company keeping all of the past years' paid premium while never having to pay out a death claim.

Several insurers that maintain a career agent field force have accomplished this objective by preventing their agents from discussing the option of a life settlement with their clients under the threat of the company terminating their agent’s contracts.

The concept of “active concealment” of the life settlement option is pervasive among many insurers, as lapsed policies can be major sources of profits.

As a result of the COVID-19 pandemic, many individuals have unfortunately found themselves in a situation where they either can no longer afford to pay the premiums on their existing life insurance policies, or need to raise much-needed cash to pay for other essential needs. In either situation, you as their trusted advisor should make them aware of this little-known option, which may be a valuable alternative for any individual over the age of 70 in a declining state of health.

Taxation of a life settlement

The tax basis for a life settlement is based on the premiums paid into the policy. Any cash surrender value in excess of the basis is taxed as ordinary income. Any value received above the cash surrender value is taxed as a long-term capital gain.

For example, if the premiums paid were $100,000 and the cash surrender value is $110,000, then $10,000 is taxed as ordinary income. If the value of the life settlement is $200,000, then $90,000 is subject to long-term capital gains taxes.

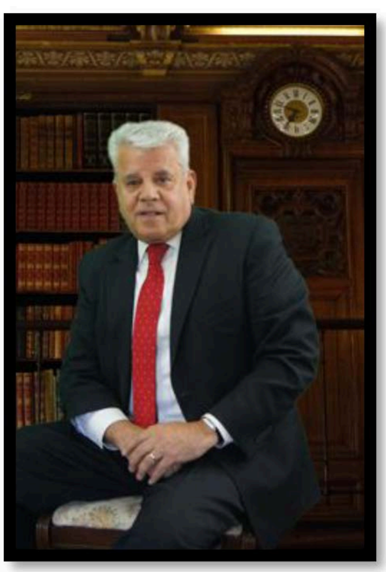
Payment options available to the seller

Life settlement payment options can take the form of cash, a retained death benefit interest for the seller, or a combination of cash and a retained death benefit interest. The offer amount usually depends on the life expectancy of the insured, as measured by no less than two life expectancy reports from credentialed third-party firms, plus the opinion of the investor’s internal medical staff. A cash offer is less complicated and, therefore, the most frequently requested type of offer. A retained interest offer amount can be more favorable to the seller because the buyer has no upfront cash outlay and the seller is paid from participation in the death benefit proceeds.

For example, an 82-year-old client in fair health no longer had a need for his $3.5 million death benefit with a $1,210,000 cash surrender value. He was in the process of filling out the cash surrender form from the insurance company when he mentioned the transaction to the attorney who initially drafted the trust. Fortunately, the attorney suggested that the client explore the possibility of a life settlement. Once the client's medical records were obtained, and after several rounds of negotiations with several institutional investors, the client received a $1,810,000 life settlement offer from the secondary market, which the client gladly accepted.

The secondary market provides a better exit strategy for a client who finds their life Insurance policy is no longer affordable or no longer needed for estate tax purposes, or who perhaps have a more immediate need for cash today. While the responsibility of managing a life policy rests with the owner of an insured's life insurance policy, keep in mind that 90 percent of such owners are the sons, daughters and friends of the insured acting as unskilled or accommodation trustees. The other 10 percent acting as professional trustees are fully aware of their client's options.

So, rather than having your client merely surrender their life insurance policy back to the insurance company simply because it's more convenient, or because they're not aware of any other alternative, consider educating your client about life settlements.



Henry Montag CFP, CLTC
thetolicentereast.com
516-695-4662