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INSURANCE ISSUES

Clients can recover significant wealth that may be trapped in unneeded life insurance.

New Value in Old Policies

BY NEIL ALEXANDER

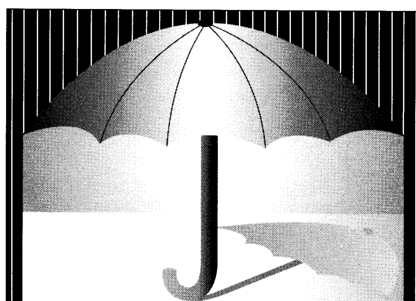
Many clients have life insurance policies they view as unnecessary because they no longer meet their original need. As estate tax rules change and the policies clients purchased to pay these taxes become unnecessary, this trend is likely to increase. JE McGowan Consulting estimates the potential secondary market for life insurance policies exceeds $18 billion annually. Before clients abandon old policies, CPAs should step in and help them recover the potentially significant wealth that may be trapped there. Allowing unneeded policies to lapse can be a costly mistake. CPAs can help both individual and corporate clients or employers sell the right to collect on these otherwise dormant assets in the aftermarket. Determining if selling a policy is a good idea is a relatively easy process for CPAs—and potentially lucrative for policyholders.

A GROWING MARKET

The growth in the secondary market for life insurance policies has soared over the last decade.

- In 1990, only six companies made an active secondary market. They purchased about 500 policies with a face value of between $40 million and $50 million.
- Today, the Federal Trade Commission estimates that $500 million in life insurance policies are sold annually on the secondary market. With companies entering and leaving the market, it's difficult to estimate the number of active participants.
- Actuarial data suggest 40% of all policies on people age 65 and older will not be held to maturity.
- The National Association of Insurance Commissioners estimates that in 1996 nearly $1.5 trillion face amount of life insurance policies expired, lapsed or was cancelled by policyholders; each policy was a potential source of wealth had the owner sold it on the secondary market.

Consumers have long viewed life insurance merely as a means of providing liquidity to pay estate taxes, to protect surviving



family members, to fund buy/sell agreements or to meet other business needs. Based on this narrow view it's no wonder so many CPAs fall into the trap of agreeing to allow unneeded policies to lapse or be surrendered for just their cash values. This is especially true if the coverage is no longer necessary and the premiums have become burdensome. However, this may be bad advice since such policies often have a secondary market value far exceeding their cash value.

Case study. A 76-year-old man owned a policy with an $8 million face amount and a $795,000 cash surrender value. He sold the policy for $2.3 million rather than let it lapse, cancel it or take the cash value. Had he not sold it, he would have left at least $1.5 million on the table.

HOW TO IDENTIFY THE RIGHT CIRCUMSTANCES

Many types of insurance policies qualify for settlement, including term, whole, variable or universal life, any type of survivorship, adjustable life, joint first to die, group (if convertible) and retired lives reserve. The aftermarket for life insurance operates in two areas—viatical and lifetime settlements—each with different tax implications.

Viatical settlements involve the sale of a policy insuring the life of someone who is either terminally or chronically ill. Proceeds are free of federal income tax and state income tax in some states (such as New York and California) since they are considered a death benefit.

Lifetime settlements are for people without the health problems required for viatical settlements but with a life expectancy of 15 years or less. According to current mortality tables, this means males age 70 or older and females age 74 or older. Sometimes the insured has simply outlived his or her family or beneficiaries. Clients should also consider selling an unneeded life insurance policy when they can use the proceeds to:

- Liquefy an otherwise dormant asset.
- Fund new, more cost-effective life insurance coverage.
- Create funds to make other investments.
- Fund an outright charitable gift or charitable trust.
- Make cash gifts to other family members.

Corporations should consider selling unnecessary life insurance policies on employees' lives if:

- The company has been sold to a third party and the policies' original purpose was to fund a buy/sell agreement on one partner's death.
- The insured key person retires or is no longer involved in the business.
- The policy is part of litigation among partners.
- The company must sell assets to raise cash.
- The policy was purchased to fund deferred compensation or other benefit programs that have now changed.

Businesses may also benefit from selling a policy in the secondary market to

- Purchase an interest in another enterprise.
- Facilitate the transfer of a business to the next generation.
- Repay debt.
- Buy back stock from a partner or shareholder.

BUYER'S CRITERIA

While there is no size limit on policies a consumer can sell in the secondary market, the usual face value is around $1 million. Many buyers, however, routinely purchase policies worth significantly more. Companies will even buy a partial interest in a policy. The lower the cost to carry the policy and the faster the expected payment, the more attractive an offer a policy is likely to attract. Companies that buy life insurance policies in the aftermarket use these criteria to determine the price to offer:

- *Policy face value.* Depending on the buyer, the minimum face value is seldom below $250,000—or $500,000 for some buyers.
- *Insured's age.* The older the insured, the higher the offer.
- *Health impairments.* The more severe the health condition, the higher the likely offer.
- *Existing policy structure.*
- *Existing policy value.*
- *Existing policy premium.* The potential buyer uses this to determine the cost of maintaining the policy until it pays off.

TRANSACTION MECHANICS

Once a buyer has expressed interest, selling a life insurance policy requires no medical exam. Here are the usual steps to close the deal.

- The seller submits to the buyer the necessary paperwork, including an application, a copy of the life insurance policy, an in-force ledger (an annual schedule of policy details) to age 95, an authorization form, a copy of any trust agreement if the policy is trust-owned and the insured's medical records for the past two years.
- The buyer extends an offer to buy the policy and the seller accepts.
- A closing occurs with all documents signed.
- The funds are deposited in an escrow account until the change of beneficiary and ownership is recorded.
- When the policy transfer is official, the funds in escrow are wired to the insured.

Payment structures. Payment terms are generally flexible to meet the seller's needs. The most common payment methods include lump sum, installments (to defer taxes) and annuities.

Case study. An 82-year-old woman sold a policy on her life for $900,000 that had a face amount of $5 million but a nominal cash surrender value of just $2,500. Without the sale, she would have walked away from almost $698,000.

PROFESSIONAL DUE DILIGENCE

It's important for CPAs to understand both the market and the players clients are dealing with. Life settlements are unregulated and involve substantial sums of money. Not all transactions are fair. A Texas man was indicted for buying policies from AIDS patients without paying them. On the flip side, *The Los Angeles Times* reported the arrest of several AIDS patients who concealed their condition to get insurance coverage with the intent of selling it in the aftermarket. Indeed, sophisticated buyers are sometimes wary of policy sellers who are HIV positive. With recent advancements in AIDS drugs, the life expectancy of these individuals is such that investors often receive little or no profit.

CPAs should use these due diligence guidelines to help judge the deal and the buyer.

- Gauge the market by obtaining offers from two or three companies.
- Check with your state attorney general's office or insurance department for any complaints against the possible buyer.
- Verify that the buyer has the money to buy the policy readily available. Reputable companies usually have cash on hand.
- Select or insist on a buyer who uses a reputable, *independent* financial institution to hold the money in escrow until the change of ownership closes.
- Make sure terms of the contract specify timely payment from the escrow agent—generally no more than two or three business days after change of ownership.
- Determine and disclose to your client the possible tax consequences of the transaction and implications for public assistance benefits as a result of the sale.
- Consult legal counsel regarding probate and estate considerations arising from the transaction. By definition, life settlements remove life insurance benefits from the original beneficiary's estate.
- Determine the buyer's process of administering policy investments. Some buyers contact the insured on a monthly basis to verify that he or she is still living; needless to say, some clients may find this distasteful.

TAX IMPLICATIONS

To the individual policy sellers, life settlements usually involve three layers of taxation:

- Zero tax—up to the owner's basis, since it is a return of capital.
- Ordinary income—from the basis to the policy's cash surrender value.
- Long-term capital gains—from the higher of either the cash surrender value or the federal income tax basis to the net settlement proceeds, since this is a capital asset.

WHAT'S NEXT?

By putting some research and thought into the disposition of unneeded life insurance policies, CPAs can help clients and employers realize extraordinary value from the growing secondary market. The exhibit below includes a list of resources where CPAs can get additional information on the legal, ethical and tax implications of selling life insurance policies. ■

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