THE RISE OF LIFE SETTLEMENTS

You should know if your clients should sell their insurance policies.

Sometimes CPAs are afraid of what they don't know, so they avoid it. That instinct can often be hazardous to a client's financial health.

Life settlements are the proper sale of a life insurance policy to an investor when the client is better served by forsaking steering a death benefit to heirs to gain an immediate infusion of cash.

Life settlements are sometimes confused with abusive or potentially fraudulent "STOLI" (stranger-originated life insurance) transactions. In those deals, large life policies are sold to elderly people who had no genuine need for the coverage, with the promise that the contracts will be immediately bought back by an investor and create a windfall for the insured.

Life settlements are also sometimes confused with viatical settlements, the sale of a life policy when the policyholder is in dire financial straits and has a very short life expectancy, typically due to a terminal illness.

It is a borderline fiduciary responsibility for CPAs to know whether a life settlement is an option for a client. In a recent situation, an elderly person sold a long-held insurance policy, instead of simply letting it lapse and realized significant cash. Imagine if this person had let the policy lapse and later learned that he could have sold it. He goes to his accountant and says, 'Are you kidding me? You didn't tell me I just gave up a valuable asset in my portfolio?'"

No CPA should be put in that position.

So what kind of clients might benefit from pursuing a life settlement?

There was a elderly person in his early 80s who had been dutifully paying premiums on a $500,000 face amount universal life policy with a limited cash value. When the policy was originally purchased by the client many years ago, illustrations (based on higher prevailing interest rates at the time) projected a substantial cash value by today.

That cash value could have been used to cover premiums, or paid to the client upon surrendering the policy, but because the underlying interest rate was variable and had declined consistent with bond market yields that scenario had not come to pass, and the client was still paying $35,000 in annual premiums. He asked whether he was better off simply letting the policy lapse.

His CPA knew he might have a third alternative a life settlement. Ultimately, the client received an offer of $180,000 for the policy which he accepted.

Another situation that might give rise to a life settlement involves “key man” life insurance in a business context. A lot of times the policy will be dropped when the key man retires, but the owner (of the policy) may be sitting on a gold mine.

The point isn’t that life settlements are always the smart way to go but they may be, at a minimum, an opinion for suitable clients to consider, assuming that they can find an attractive offer. At this point, there is somewhat of a standoff of return expectations of sellers versus buyers. But pools of capital are beginning to accumulate, and there will he heightened demand for life settlements.

Investors, including banks and hedge funds, were shell-shocked by losses on other investments in 2008 and 2009, and stayed on the sidelines until later in 2009. Many were also rattled when an upward adjustment in standard mortality tables used by actuaries undermined models used by institutional buyers to price their life settlement offers.

But investors are beginning to put those disruptions behind them. Investors think of life settlements as somewhere between bonds and equities on a risk scale. It is a safe asset class. People will die.

Life settlement investors, who have traditionally targeted policies with face amounts of $500,000 and above, will become more interested in policies as small as $250,000 if they can bid on them economically. Life expectancy is a key variable used by investors to determine whether to bid on a life policy, and if so, how much. Investors used to only be interested in buying policies whose owners had a life expectancy in the five-to-eight years range. Most of the buying now is done at 12 years or less.

Recent hard times have contributed to a large increase in the number of policies on the market. As retirement savings portfolios have lost value and real estate has lost value, a ‘Plan B’ has to be devised which is where life settlements can sometimes fit in.

There is an example of a man in his 70s who owns a $3 million life policy and his health has taken a turn of the worse recently, making the policy potentially attractive to an investor.

CPAs should suggest that all senior clients have their life insurance policy appraised to determine the fair market value of the policy. Even if the client does not necessarily want to exit the life policy, it’s critical that the fair market value of the life insurance policy be determined.

The fact that life settlements investors’ payoff comes only when the original owner of the policy dies means that CPAs should only steer clients to life settlements brokers who work with institutional investors, not private parties. You wouldn’t want Tony Soprano buying your policy.

But life expectancy isn’t the only variable investors consider.

Take the example of an 85-year-old whose policy that cannot sell because the premiums are too high. The higher the ratio of premiums to death benefit, the less attractive the policy.

Other considerations include the type of policy involved. For example, standard whole life policies are not typically value as highly as universal or variable life contracts. And the only term policies that investors consider are convertible policies; investors would buy them only after they have been converted to a permanent policy.

Often the most attractive type of policy is a joint survivorship policy with one spouse already deceased.

Also, policies with a significant cash value build-up tend to be less attractive to investors. Indeed, the owner of a life policy with a high cash value might be better off simply surrendering the policy and collecting the cash value.

The tax implications of selling a life insurance policy are a natural focus of CPAs in helping clients sort through this issue. A revenue ruling (2009-13) issued in May and which takes effect August 26, provides some clarification. In the ruling, the IRS “confirms its somewhat controversial position set forth in prior private letter rulings that the holder’s basis is not equal to the full amount of premiums paid, but instead must be reduced by that portion of the premiums paid expended for the provisions of insurance. The IRS does finally confirm that a portion of any gain can be capital in nature upon such a sale.

Another important planning consideration that CPAs can sort through is the existence of trusts. For example, if a life policy has been transferred to an irrevocable trust you need to make sure that the spouse is the beneficiary of that trust because otherwise, the sale of that asset to a third party might not provide the intended benefits.

In advising clients on the possible sale of a life insurance policy, it is important to involve the policy's original prospective beneficiary. That beneficiary should sign off, so there is no surprise. You don't want them to be counting on a policy, and then they find out that mom has sold it to someone.

Meanwhile, lawmakers aren't convinced that everyone will do what's right. For example, proposed legislation in the states of Maine and Washington would require life insurance companies to advise policyholders that life settlements are possible choice for those considering surrendering their policies. And Congress has taken notice of the growth of life settlements and is exploring the federal government's role in overseeing these transactions. At a Senate Select Committee on Aging hearing in April, Securities and Exchange Commission Chairman Mary Schapiro testified that life settlements may soon come under the jurisdiction of her agency.

Committee chairman Sen. Herbert Kohl, D-Wis., commented that "selling one's life insurance policy is a complex transaction, fraught with possible pitfalls."

That is precisely why CPAs need to be involved because they raise the bar in terms of integrity.