

## When Does a Life Settlement Make Sense?

- Definition of a life settlement:
  - Sale of a life insurance policy by the policy owner to a third party investor.
  - As distinguished from:
    - Surrender of life policy to issuer.
    - Viatical settlements.
- “Viatical settlements”--surrender or sale of a policy, when insured is thought to have two years or less of life remaining, owing to life-threatening illness.
  - Viatical settlements, if they meet certain requirements of the federal tax code, enjoy exclusion from federal income tax. See I.R.S., “Tax Highlights for Persons with Disabilities,” [Publication 907](#), as well as “Taxable and Non-Taxable Income,” [Publication 525](#).
  - Some insurance policies are issued with clauses providing for “accelerated death benefits” under such circumstances.
- Evolution of life settlement market
  - The modern life settlements market grew out of viatical settlement of AID’s cases in the 1980s.
    - Some desperately ill people received a financial lifeline by selling all or part of their existing life policies.
    - There were also many irregularities:
      - Some sponsors encouraged the falsification of new insurance applications by terminally ill persons. See, for example, the case of Steve Keller and Kelco ([Kelco references](#)), on which the US Sixth Circuit Court of Appeals ordered a resentencing in 2005.
      - Some viatical and life settlement brokers captured egregious fees without the knowledge or consent of the policy owners.
    - Many investors in these early viatical settlement pools suffered a disaster, as the development of the “AIDS cocktail” approach fortunately saved many AIDS victims from premature death. Litigation continues even now against some of the early sponsors of these investment programs.
- A life settlement makes sense to consider if:
  - The policy owner is actively considering the abandonment or surrender of an insurance policy
  - The life settlement market offers a bid higher than that available by surrendering the policy to the insurance company issuer
  - The policy owner no longer needs or cannot afford to keep the existing policy in force.

- The tax consequences of a life settlement have been discussed with the policy owner's accountant or attorney. (Greenwich Financial Management can provide referrals, if needed.)
- Regulatory considerations:
  - In many states, with certain exceptions, only a licensed life settlement broker may broker a life settlement, and only a licensed life settlement provider may invest in one.
  - The insurance commission of the state you live in will be able to address questions you may have concerning the regulation of life settlements in your state, as well as being able to confirm the identity of licensed brokers and providers.
- Market considerations:
  - The life settlement market is rather inefficient and illiquid.
  - It pays to find a competent and ethical broker. Ask for proof of the broker's licensing status in your state.
  - You should engage the broker through a contract. The contract should spell out your rights as a seller.
    - You will want to restrict resale of your policy to an "institutional investor," as opposed to individual investors and partnerships.
    - You should have the right to receive notice of each bid received and the identity of the bidder.
    - You should have the right to receive a full disclosure in writing of the "gross offer" (the full price) made by the buyer as well as a breakdown of any commissions. Make sure this document is attested to by the agent and management of the broker. Do not accept disclosure of the "net price" alone (the price after commissions).
    - An accepted standard for commissions in this market is 2% of the death benefit of the insurance policy.
    - Make sure that the contract clearly indicates that the net payment to you as policy owner is free of any obligation to pay brokerage fees.
    - Make sure the contract identifies the broker as agent for you as the seller and confirms that the broker accepts a fiduciary duty to you to obtain the best available market price from a reputable buyer.
    - Have the contract reviewed by an attorney experienced in such matters. (Greenwich Financial Management can provide referrals to competent independent attorneys.)
- Preliminary matters:
  - If you should decide to ask a broker to offer out your life policy for sale, you will generally be asked to complete the following forms to start the process:
    - HIPAA release (federal privacy law)
    - Health status questionnaire
    - Release of medical records from your doctors
    - Information questionnaire

- A broker will usually seek an official evaluation of your life expectancy:
  - Major firms evaluating life expectancy include American Viatical Services, 21<sup>st</sup> Services, Fasano, EMSI, Bragg Associates and Midwest.
  - These life expectancy services work from your medical records alone; you will not be asked to undergo a medical examination.
  - The broker will generally pay the fee to obtain life expectancy estimates, hoping to recover this cost through the hoped for brokerage fee.
- Closing documents:
  - If you agree to a viatical or life settlement, the closing documents will include the following:
    - Purchase agreement.
    - Various “tracking” forms, usually identifying three individuals who are responsible to report to a servicing organization in the event of your death.
    - Acknowledgments by “interested parties,” including spouse, if any.
    - Limited power of attorney, granting the servicer certain legal rights in the event of your death.
    - IRS form W-9.
  - These documents should be reviewed by an attorney qualified in these matters. (Greenwich Financial Management can provide referrals.)
- In most states, the “viator” (seller of a viated policy or a life settlement) has a right to rescind the sale for a short period.
- Tax consequences of life settlements:
  - For the sake of conservatism, assume that the sale of a life settlement will create income realized in the tax year you receive the life settlement. Do not fail to report such income—whether or not you receive a Form 1099 from the life settlement broker. The consequence of failure to report income to federal, state and local authorities can include civil and even criminal sanctions.
  - The I.R.S. has taken the position that premiums paid on a life insurance policy may be considered “basis,” but this basis must be reduced by two factors: the value of any life insurance protection received and the amount of any dividends previously paid out. For practical purposes, according to the IRS, total premiums paid, minus present cash or surrender value, effectively equals the value of life insurance protection received. Thus, in the case of a permanent life policy with no cash value, the basis may be zero. See, for example, this clear statement: [Advice of the IRS Chief Counsel](#) (2004). Private Letter Ruling #9,443,020 (1992) reached the same conclusion using a slightly different analysis.
    - Some market participants take the position that life settlements on life policies held by the insured person/policy owner for more than one year should be eligible for treatment as long term capital gains for federal income tax purposes. This would imply treatment of the life policy in the hands of the original policy owner as a

“capital asset” under the Internal Revenue Code, and further, that this capital asset is one entitled to capital gains treatment.

- Others also take the position that premiums paid on a life insurance policy, which effectively pay for the cost of mortality rather than contributing to cash value, ought to form part of the taxable “basis,” thereby reducing the income tax impact of a sale. This reasoning may be by analogy to the rules governing borrowing from the cash value of a life insurance policy by a policy owner.
- A synthesis of the above positions asserts that “any amount paid for a life insurance policy in excess of the cash surrender value would be treated as a capital gain [assuming adequate holding period], with the difference between the tax basis (i.e. total premiums paid) and the cash surrender value being taxed as ordinary income.” See Conning & Company, “Viatical Settlements: The Emerging Market for Life Insurance Policies,” (by private subscription, 1999), p. 21. In this view, the ordinary income element would be limited to that increment by which cash value accumulates beyond the amount representing premiums paid.
- Some of these views are apparently at variance with the posture of the IRS, but possibly could be sustained in litigation in federal administrative tribunals, the Tax Court, or other federal courts. Congress, in its enactments of the Internal Revenue Code, has not clearly anticipated or addressed these issues, as they apply to life settlements.
- Brokerage commissions paid to effect a life settlement reduce economic gain and ought to be deductible, and there are many analogous situations involving investments where it would be. Under the present structure of the life settlement brokerage market, the seller of a life settlement receives a net payment, and the broker(s), if any, receives separate commission payment(s) from the life settlement provider. Under the present system, the seller never receives any of the funds payable to the brokers, so there would seem to be a strong case that those separate payments to the brokers do not create taxable income to the seller.
- According to the IRS position, in a brokerless life settlement, with proceeds of \$7,500,000, no cash value, and consequently taxable basis of zero, the taxable gain would be \$7,500,000. If the holding period of the policy was at least one year, there is an argument that capital gains treatment may be merited, but the regulations and case law are not clear on this point.

IRS Circular 230 Disclaimer: To ensure compliance with IRS Circular 230, any U.S. federal tax advice provided in this communication is not intended or written to be used, and it cannot be used by the recipient or any other taxpayer (i) for the purpose of avoiding tax penalties that may be imposed on the recipient or any other taxpayer, or (ii) in promoting, marketing or recommending

to another party a partnership or other entity, investment plan, arrangement or other transaction addressed herein.

Greenwich Financial Management Inc. does not give tax advice and does not practice in the fields of accounting or law. This summary document is no substitute for the customized professional advice that you may seek from your accountant or lawyer.