TRUST-OWNED LIFE INSURANCE RESTRUCTURE - AN ADVISORS GUIDE TO VIATICAL AND LIFE SETTLEMENTS

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There is a lapsing life insurance policy crisis. Attractive options are available to safeguard the policyowner's investment. Yet, for the reasons described in our prior five (5) articles, consumer awareness of the life insurance market, both the primary and secondary market, is minimal as evidenced by this crisis. Legal, tax and fee-based life insurance advisor guidance is available – it just needs to be used.

Given the lapsing policy crisis and its adverse implications for older insureds, this article discusses the all-to-often overlooked role of the secondary market. The secondary market, known as the settlement market, is arguably the most significant 'value-added' component of the life insurance asset class. Life insurance is more than a financial asset – it is an asset class usually described in text books as 'low risk'. This asset class has primary and secondary markets, and management tools that provide for customized policy design and forward-thinking risk identification and management. The secondary market for un-needed, un-affordable and un-suitable policies significantly enhances the life insurance planning options available to insureds age 65 and older. It offers a 'market value' exit strategy as compared to the traditional less-attractive carrier options – policy surrender for its cash value (net of surrender charges) and policy lapse without value.

It is important to note that the settlement market post-2008 is very different from pre-2008 when settlements were the target of abusive compensation-motivated marketing schemes. The professionalism of established 'providers' who represent buyers has combined with the initiative of state regulators to safeguard the interests of policy sellers. The settlement market should not be overlooked.

Focusing on Trust-Owned Life Insurance (TOLI), the secondary market offers skilled and unskilled trustees attractive policy management options. A TOLI policy is typically purchased for management over a 10 to 40 year time horizon. Trust objectives, trustee risk tolerance, tax legislation and life insurance products frequently change, meaning changes may also be needed to the trust assets. While trustees, attorneys and accountants are generally familiar with the terms 'Life Settlement' and 'Senior Settlement', frequently they are not familiar with how settlement works or how to manage a settlement transaction. Further, even seasoned professionals may not be aware of how a life settlement combines with the new generation of senior-appropriate life insurance products to generate a more cash flow and tax efficient life insurance management plan. Following is a brief discussion of basic settlement considerations.

Viatical and Life Settlement – These two settlement types involve the sale to a third-party of an in-force life insurance policy for its 'fair market value', usually a cash payment to the seller in excess of the policy's cash surrender value but less than its death benefit. The purchaser acquires policy ownership, becomes the beneficiary, and is solely responsible for future premium payments. The sale process usually takes 8 to 10 weeks and does not require medical examination. A viatical settlement involves an insured with a life-threatening illness expected to die within 24 months whereas a life settlement involves an insured without a life-threatening illness expected to live longer. While settlement payment is typically cash, it can also take the

form of a 'retained' interest in the death benefit as well as combination cash and retained death benefit interest. The purchase agreement terms will vary depending upon the form of payment.

Settlement Mechanics - All policy types can qualify for a settlement including: whole life, universal life, variable life, term, survivorship, and group if convertible. Most institutional purchasers prefer to buy policies with face amounts in excess of $250,000 underwritten by carriers having minimum BBB financial ratings and insureds having a 2-12 year life expectancy along with an unfavorable change in health status since policy issue. The amount paid to the seller depends on insured age and health, carrier ratings, premium cost to maintain the policy in-force, policy cash surrender value, policy face amount, and the existence of loans against cash surrender value.

Situations Appropriate for Settlement - Individuals, businesses, trustees and charities should consider Life Settlement when a policy is no longer needed or suitable due to planning purpose changes. Situations appropriate for Insurance Trusts include:

- Insurance policy liquidity no longer needed due to gifting or other estate asset/tax law changes.
- Change in trust objectives requires larger policy or different product type.
- Policy under-performance requires restructure to avoid lapse or unmanageable costs.
- Trustee prefers a guaranteed death benefit policy.

Sample Life Settlement Case - The trustee of a $1,000,000 trust-owned policy received a lapse notice and involved the client's legal and tax advisors in evaluating options. The insured was an age 79 female. The universal life policy was issued 20 years ago and the insurance agent retired shortly thereafter. The trustee obtained an in-force illustration projecting a significant annual premium increase to sustain the policy. Alternatively, after reviewing competitive proposals for a 'no lapse guarantee' universal life policy and obtaining an expression of underwriting interest based on the insured's current medical information, the trust purchased a guaranteed death benefit policy that required less premium outlay. Simultaneously, the trustee sold the lapsing policy for $75,000 and thereby generated $74,505 more than the $495 cash surrender value. The proceeds were used to purchase the new policy.

Life Settlement Tax Implications - Revenue Ruling 2009-13 issued May 1, 2009 clarified that a policy seller may not use the amounts paid for "cost of insurance" charges to increase tax basis or reduce taxable gain. Under case law discussed in the ruling, the IRS takes the position that a portion of premiums paid represents personal consumption of life insurance protection (the cost of insurance amount) and only the remainder of the premiums paid is the cost of an asset. As a result, policy sellers to third parties must obtain their "cumulative cost of insurance" information from the life insurance company in order to calculate the adjusted basis (premiums paid less cost of insurance) and file their tax returns.

Further, the IRS takes the position that the difference between policy cash surrender value and premiums paid, the net inside build-up the policyholder would have received upon a surrender, is taxable as ordinary income and the remaining offer balance is treated as capital gain.

Also, a policyholder's tax basis in a pure term life insurance policy having no cash value is limited to the amount of any unearned premium with the offer balance treated as capital gain.

The tax implications of any settlement transaction should be reviewed with the policyowner's tax advisor.

Settlement Licensing - Licensing requirements for brokers representing policy sellers and providers representing policy buyers vary by state. For example, some states require life insurance agents to also obtain special licensing to engage in settlement transactions. State licensing requirements should be confirmed as part of the broker 'due diligence' selection process.

Settlement Compensation – Broker compensation has become a negotiated amount that varies by policy size, transaction complexity, scope of broker services and periodically by provider (buyer) guidance. For many years, an industry benchmark was the lower of 6% of the death benefit or 30% of the gross offer in excess of policy cash surrender value, with compensation paid by the 'provider'. The seller typically requests the names of all brokers or agents receiving payment along with amount and terms. Broker compensation is an essential 'due diligence' consideration that should be formalized, along with expected scope of services, in the broker engagement arrangement.

Broker Selection – All brokers are NOT the same. Skilled and unskilled trustees should only consider experienced brokers who can access the majority of established providers and offer a scope of transaction services appropriate for the proposed transaction.

In conclusion, the secondary market poses an attractive market value exit strategy ideally-suited for lapsing policies and older insureds. For TOLI, it is a basic asset restructure option especially if trust objectives change, recognizing that the basic duty of the trustee is to maximize the probability of favorable outcome to the trust estate. While skilled trustees are generally familiar with the settlement option, most unskilled trustees are not and, hence, rely upon a legal or tax advisor for ILIT administration and TOLI risk management guidance. As a result, advisor guidance plays a critical role in performance of the unskilled trustee's duties. To insure appropriate fiduciary intervention, professionals should undertake the following actions:

1. Determine, with the assistance of an experienced settlement consultant, if the settlement option is appropriate for a client's situation.
2. Review multiple offers received from licensed institutional purchasers who meet the client's screening criteria.
3. Discuss all offers with client to evaluate the most favorable financial and non-financial terms.

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