

# P E N N S Y L V A N I A

---

# LAW WEEKLY

Monday, January 5, 2004

Vol. XXVI No. 52

ALM

## COMMENTARY

### An Often Overlooked Asset

*A life settlement, created by the sale of a life insurance policy, must be considered for clients*

**BY ARNOLD MACHLES AND  
RAY S. GREENBERG**

*Special to the Law Weekly*

**C**hanges in the insurance industry have created scenarios that could generate claims of malpractice if not properly addressed.

For instance, when divorce lawyers meet with the equitable distribution master (or even before), and somebody mentions a term life insurance policy, it is almost a knee-jerk reaction to treat it as valueless. Generally, all agree that this is just a throwaway. Wrong approach!

Dramatic changes both within and around the insurance industry have given new value to what once was considered to be a non-asset. These changes must be further explored. Many term policies, as well as traditional permanent policies, may now have a fair market value, and it could possibly be malpractice on the part of the attorneys representing the parties to overlook it.

While many attorneys are already familiar with viatical settlements, life settlements are the next generation and offer enormous planning potential. A brief view of the industry will help us understand how a seemingly non-asset becomes a valuable asset.

#### VIACIAL SETTLEMENTS

The business of selling existing life insurance policies can be traced back to England in the middle 1800's. But it was not until the epidemic rise of AIDS cases in the 1980's that the practice of selling existing policies appeared in a big way. Insureds suffering

from the dread disease needed money immediately to purchase expensive care or experimental pharmaceuticals, and maintain basic lifestyle, all while unable to work because of the disability from the disease. Insureds who were in this position, found a ready market for the purchase of their life insurance policies which were likely to become death claims in a relatively short time. The cash payments received provided funds that could be used to pay for medical expenses, for ordinary bills, or for any other use desired.

These sales were known as viatical settlements. Because the purchase of policies under the dire circumstances mentioned created opportunities for abuse, many states adopted regulatory legislation. See the Viatical Settlements Act codified at 40 P.S. Section 626 et seq.

With the introduction of new pharmaceuticals, AIDS is no longer the death sentence it once was. But the door has been opened to a new and growing business. That is the sale of an otherwise dormant, under-performing or unnecessary asset, such as a term life insurance policy, for valuable consideration. These transactions became known as life settlements, lifetime settlements, senior settlements, or high net worth settlements (collectively "life settlements" in this article).

#### 'LIFE SETTLEMENT' DEFINED

A life settlement is the sale of an existing life insurance policy for a cash payment (fair market value) that is greater than the policy's cash surrender value (greater than zero in a term policy) and less than the death benefit. A life settlement enables a term life insurance

policy owner to access value from an asset that heretofore was available only after the insured passed away, or for an owner of a whole life, universal life or variable universal life policy to obtain *more* than the cash surrender value.

Policies, which otherwise might be lapsed or forfeited without value or sold for less than value, can now be sold to a ready market of investors, if just a few conditions are met. Generally, the conditions are that the insured is at least 65 years of age, the insured has experienced a decline in health since issue, life expectancy is 15 years or less, the face amount of the policy is at least \$100,000, and the policy is beyond the two-year contestable period.

#### WHY SELL A POLICY?

There are many circumstances in which a life insurance policy may no longer be needed, yet have enhanced value to the owner. Here are some of those circumstances:

**Buy/sell agreement:** A policy previously purchased to finance a buy/sell agreement is no longer needed after one or more of the participants leave the business or it has been sold to a third party.

**Key man:** A key-man policy is no longer necessary because of a change in ownership, or the insured executive is no longer employed by the business.

A policy that has been used to fund a deferred compensation or other executive benefit program is no longer needed as the plan has been changed.

**Business bankruptcy:** Company-owned insurance on an owner or key employee is an asset that is not exempted in a business bank-

ruptcy. If a term policy exists, it may be an asset which otherwise might be ignored. If a policy with cash values exists, it may be an asset with greater value than the cash surrender value would suggest.

**Estate tax needs have changed:** The insurance originally purchased because of estate tax liability may no longer be needed for several reasons. The market value of the taxable estate may have been seriously eroded by poor investment performance, or liquidity may have been greatly increased by superior performance. Larger estate tax credits already in place, and due to increase in the future, may exceed the estate tax liability. Or other planning, such as gifting or charitable bequests have had an opportunity to sufficiently reduce the need for the insurance.

**Three-year look-back:** Insurance may be needed for estate planning purposes, but transferring an existing policy, subject to estate taxes, into a trust would trigger a three-year look-back period. It might be in order to replace the policy with one owned by an irrevocable trust avoiding the additional estate taxes.

**Children are grown:** Insurance purchased while the children in the family were young is no longer needed as there is no longer a need to support them (despite what they tell us) or the insured is finished writing tuition checks.

An individual has a change in financial condition, and the premium is no longer affordable.

The insured has had the longevity to outlive the intended heirs and beneficiaries.

Having borrowed against the cash values in the policy, the cost of maintaining the policy is too high.

**Underperforming insurance contract:** When issued, the policy premium was based upon the insured's age and condition of health, as well as earnings and expense projections for the contract. After a number of years, this produces several things in regard to the value of the policy. First, as discussed above, there may no longer be a need for the coverage. Also after

*Arnold Machles, Esq. is a sole practitioner practicing in Bala Cynwyd, Montgomery County. He is a former chairman of the family law section of the Philadelphia Bar Association and is a fellow of the American Academy of Matrimonial Lawyers. Ray Greenberg, a Certified Financial Planner™ and practitioner, is the founder of Financial Expertise, which services clients from Feasterville, Bucks County, and has over 30 years experience providing long-term insurance and investment planning.*

a certain age or after being in force for a certain number of years, the policy premium may increase to the point where the premiums become a burden on the insured. Or, the earnings and expenses projected may have been too optimistic, thus requiring additional unanticipated premiums.

In the case of a policy which is not performing as predicted, the client might be better off exchanging policies or raising cash through a life settlement and purchasing a new policy or investing the proceeds.

**In a divorce setting:** This is where this article started. If an insurance policy won't be needed to fund child support or alimony, the policy may no longer be needed for any purpose and the value may be included as a marital asset. If the policy is needed but underperformance puts the future of the policy in jeopardy, a settlement and replacement might be in order.

Since a life insurance policy can be sold, it has value as an asset in determining equitable distribution in divorce. Additionally, the value of a non-term policy may be higher than the cash surrender value (as discussed above) so looking at the cash surrender value of that policy may not be appropriate if the conditions discussed above apply (especially a detrimental change in the health of the insured).

A policy no longer needed for estate tax purposes because of divorce may be sold, adding to the distributable assets. Perhaps a second-to-die policy purchase for estate tax purposes may contain a provision allowing it to be split among the insureds, and the now unnecessary coverage may subsequently be sold.

## TAX CONSEQUENCES

The tax treatment of the gain from the sale of life insurance was treated as ordinary income until the passage of the Health Insurance Portability and Accountability Act (HIPAA) of 1996. As a result, viatical settlements were income tax free for chronically ill and terminally ill insureds. Under Internal Revenue Code Section 101(g), for sales after January 1, 1997, the proceeds of the viatical settlement would be free of federal income taxes if the viator (seller/insured) had less than a two-year life expectancy, and the policy was sold to a "qualified viatical settlement provider".

The proceeds from a Life Settlement are taxed substantially differently than those from a viatical settlement. While viatical settlements are taxed the same as life insurance benefits (i.e. no income tax), Life Settlement proceeds are taxed first as though the policy had

been surrendered, and then as an investment.

No tax is due on moneys received up to the tax basis (premiums paid less non-taxed dividends) as this is a return of capital. The difference between the tax basis and cash surrender value (if any) is taxed as ordinary income. Any proceeds of the sale in excess of the cash surrender value will then receive favorable treatment by being taxed as capital gains.

## THE PROCESS

A life insurance policy is considered to be personal property, like a car or stocks or bonds. Like those assets, it legally can be bought or sold in accordance with the applicable laws. All rights and obligations of the policy may be transferred to a third party for a cash payment. All future premium payments are then the responsibility of that life insurance policy's new owner. Upon the insured's death, the benefits are payable to the new owner.

Medical information is the first thing that is necessary in order to put a package together for presentation for an evaluation. Also included would be a copy of the in-force policy with an illustration of future performance projections. Typically, no medical examinations or blood samples are required, though the HIPAA regulations will require the cooperation of the insured.

The completed package is then presented to multiple private investor groups for offers. A typical example could be a million-dollar policy owned by someone with a substantially debilitated health condition that could possibly be worth \$200,000, or more, to an investor group. The purchase price of the policy increases as the life expectancy of the insured decreases. The lower the ratio of anticipated premium to face amount, the higher the likely purchase price. Sometimes, the purchaser will require conversion of the policy to a whole life, universal life, or similar type policy in order to be able to complete the transaction, but this can be accomplished with the assistance of the broker.

## CONCLUSION

In many contexts, an insurance policy that appears to have no value or a limited cash surrender value may have an unexpected worth. The attorney has an obligation to analyze the circumstances to determine if a life settlement is possible to gain the most for the client. ■