STEPHAN R. LEIMBERG AND ALBERT E. GIBBONS

Life Settlements and the Planning Opportunities They Offer

In this column, we interview Martyn S. Babitz regarding strategies using life settlements. Marty is an attorney and senior wealth planner with PNC Advisors' Wealth Planning Group in Philadelphia.

Types of settlements

Leimberg/Gibbons: [1] The sale of an existing life insurance policy by the policyowner, a process often called a "life" or "lifetime" settlement, is an important alternative to merely allowing a policy to lapse, surrendering it to the insurer that issued it, or even retaining the policy until the insured's death.[2] Attorneys and accountants as well as insurance specialists and other financial advisors must understand the opportunities, advantages, disadvantages, and costs of a sale of existing life insurance.

Marty, what is the difference between a "viatical" settlement and a "senior" (sometimes called high net worth) settlement?[3]

Babitz: A viatical settlement is an arrangement under which a terminally ill individual sells his or her policy for the immediate receipt of cash. A senior or life settlement is an arrangement under which an individual over age 65,[4] who may or may not have medical conditions affecting his or her health,[5] sells his or her policy for the immediate receipt of cash.

Leimberg/Gibbons: Obviously, the shorter the life expectancy of the insured, the greater the percentage of the face amount that will be paid for the policy. For example, with a 12- to 14-year life expectancy, the purchase price could be as low as 1% and range as high as 8% of the face amount. For an insured with a two-year life expectancy, the amount paid might approximate as much as 70% of the face value. But aside from life expectancy, what other factors help determine the actual lump-sum[6] amount that a policyowner will receive on the sale?

Babitz: The actual amount a policyowner will receive from a viatical or senior settlement will depend on numerous factors, including:

1. the type of policy being sold,
2. the face amount (death benefit) of the policy,
3. the amount of future premium obligations (which will no longer be the insured's obligation),
4. the policy's existing cash value,
5. the insurance company,
6. the amount of any loans against the policy, and
7. current interest rates, assumptions, and mortality expenses.

Additional factors that may affect the amount receivable include the maturity date of the policy, the domicile of the owner, any outstanding policy loan interest, and whether an auction environment can be created. The overwhelming factor in the determination of whether or not there will be a life settlement offer and the amount that will be paid is health-related—i.e., has there been a significant and adverse change in the insured's health since the policy was issued and, has the insured, as a result, suffered a meaningfully impaired life expectancy? This is essential! There must be a substantial reduc-

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tion in the insured's life expectancy or there is little possibility that much more than the policy's cash value will be paid—or that an offer will even be made.

Leimberg/Gibbons: Please explain the income tax implications of a life settlement sale of an existing policy.

Babitz: Existing income tax laws make viatical settlements an attractive method by which the owner of a policy may receive cash in exchange for an existing life insurance policy without incurring any income tax liability.[7] Under Section 101(g)(2), an individual who is "terminally ill"[8] may sell his or her policy to a viatical settlement provider, and the proceeds received from the sale will be income tax-free. A person who is "chronically ill"[9] may sell his or her policy to a viatical settlement provider, and the proceeds will be income tax-free—up to specific amounts.

The income tax ramifications for an individual who is not terminally ill or chronically ill may also be favorable. The income tax results of such a sale are:

1. The amount received—up to the seller's basis[10]—is considered a return of principal and is not subject to income tax.
2. The amounts received in excess of basis are taxable.[11]

For example, consider the following scenario. Janet, who is not terminally ill or chronically ill, owns a policy with a face value of $1 million. She has a basis of $200,000. The cash surrender value of the policy is $300,000. Janet sells the policy to a viatical settlement provider for $600,000. The first $200,000 will be a return of principal and not subject to tax. According to a KPMG/PeatMarwick opinion letter[12] to Viaticus (dated 12/2/97), which has been updated and repeated to other providers, there would be a capital gain of $300,000, equal to the difference between the $600,000 sale price and her cash surrender value. There is ordinary income of $100,000, equal to the difference between the cash surrender value and the taxpayer's basis.

Life insurance used for liquidity

Leimberg/Gibbons: Life insurance is a key planning device to provide liquidity for the payment of death taxes. This liquidity is particularly important when death tax-generating assets of a client's estate are not easily sold for their full value within the nine months following death when the tax is due. How would changes in the federal estate tax laws affect the need for life insurance for this purpose?

Babitz: Recent[13] and potential changes[14] in the estate tax laws—

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[1] The expertise and insight of Mort Greenberg, JD, CLU (mpgjd@aol.com), a wholesale life settlement broker and pioneer in this rapidly emerging industry, was much appreciated and exceptionally helpful in the preparation of this column. Mort's wealth of practical experience and generous guidance were invaluable. We'd also like to thank fee-only insurance advisor David Barkhausen (david@lifeinsuranceadvisorsinc.com) for his many highly practical and sobering comments and critique.

[2] See Greenberg and Graham, "Life Settlements: A New Option For Excess Life Insurance," 31 Colo. Law. 99 (Oct. 2002), and Zaritsky and Leimberg, *Tax Planning With Life Insurance* (800-950-1216).

[3] "Financial and Estate Planning Trends," 77 Taxes 31 (Jan. 1999).

[4] There is at least one major provider that will acquire policies insuring people under age 65. Several others will acquire policies insuring people under 65 who have a life expectancy of less than six years. Except in very rare circumstances, without a change in the insured's health, providers will not be able to make an offer for a contract.

[5] Providers typically purchase policies only when the insured has an estimated life expectancy of 14 years or less.

[6] Although it is possible for senior settlements to be structured so that the payment to the policyowner takes a form other than a lump-sum payment (for example, installment payments or a contractual agreement to share the death benefit with the present beneficiary), none of these payment methods are commonly used.

[7] Under Section 101(g)(5), there is an exception to the general rule of income tax-free treatment. This treatment does not apply to any amount paid to any taxpayer other than the insured if the taxpayer has an insurable interest in the life of the insured by virtue of the insured being a director, officer, or employee of the taxpayer or because the insured is financially interested in any trade or business of the taxpayer.

[8] A "terminally ill" individual is defined as an individual who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death in 24 months or less after the date of the certification.

[9] A "chronically ill" individual is an individual who has been certified by a licensed health care practitioner as (1) being unable to perform (without substantial assistance) at least two activities of daily living for at least 90 days due to a loss of functional capacity, (2) having a similar level of disability as determined under applicable Regulations, or (3) requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment.

[10] Basis is the amount the taxpayer has paid as premiums less any amount received tax-free under the contract (e.g., dividends).

[11] The amount received which is greater than the basis but less than the cash surrender value will be ordinary income. See Ltr. Rul. 9443020, which provides that amounts exceeding basis are taxable as ordinary income (i.e., in the pre-life settlement environment of 1994, this ruling generally treats all proceeds over basis as ordinary income). The argument of the KMPG opinion letter and those following that position is that the life settlement/senior settlement type transaction would be treated differently if those facts were currently before the IRS. This line of reasoning assumes that the portion of the sale proceeds over the cash surrender value is more of a capital asset transaction, resulting in capital gain.

[12] Although widely followed, this tax treatment has not been confirmed by any letter ruling, Revenue Ruling, or other official IRS pronouncement.

[13] The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) does not permanently repeal the estate tax, but does make significant changes to prior law. These changes will subject fewer estates to estate tax and will reduce estate tax liability for other estates. For instance, under EGTRRA, the applicable exclusion amount increased and is scheduled to increase further over the next several years. EGTRRA also reduced the top estate tax rate and provides further reductions over the next few years.

[14] Bills are introduced in Congress almost daily either to make the scheduled one-year repeal permanent, or to compromise and retain the estate tax but increase the exemption substantially, perhaps to $3 million or $4 million per person.

either in the form of outright repeal or increased exemption amounts and reduced tax rates—may cause some of these policies to be unnecessary for liquidity purposes. For example, under prior law, when the applicable exclusion amount was scheduled to be $1 million for decedents dying in 2009, an estate of $3.5 million would owe estate tax exceeding $1.1 million. Under current law, this same estate will owe no federal estate tax in 2009. Selling an existing policy originally acquired to pay estate tax would provide the policyowner with cash for current needs and goals as well as for later distribution to heirs. Rather than continuing to pay premiums for such a policy without any current benefit to the owner, the policy can be sold and the owner can receive cash now.

Leimberg/Gibbons: But you are not advocating that all life insurance purchased for estate liquidity purposes be sold?

Babitz: No one can be sure the estate tax will be repealed—or that if it is—whether the repeal itself will not be repealed. History has made fools of many who have relied on estate tax repeal in the past. Similarly, the scheduled reductions in rates and increases in applicable exclusion amounts may be frozen if deficit problems continue to grow. Aside from federal estate taxes, liquidity may be needed to pay state death taxes, debts, estate administration costs, and other expenses. And the increasing cost of living—as well as increased levels of living—may prove to be an important substitute need for insurance coverage.

So in many cases, a lifetime sale of a policy originally acquired for estate liquidity purposes may be inadvisable. Many individuals will want to retain life insurance coverage to enhance the total wealth passed to the next generation—and the demise or reduction of the estate tax will only facilitate the accomplishment of that goal.

In addition, if the policy is held in an irrevocable trust, the insured(s) may not be able to access the proceeds from the sale of the existing policy. In such cases, it may be possible for the insured to purchase the policy for its interpolated terminal reserve plus unearned premium (assuming that this is, in fact, the fair market value (FMV) of the policy) from the trust and then sell the policy for a higher amount. In this situation, the insured would enjoy the benefit of the "spread" between the proceeds of the sale and the amount paid to purchase the policy from the trust.[15]

Personal planning

Leimberg/Gibbons: Could a life settlement be structured to avoid estate tax inclusion under Section 2035's three-year rule?

Babitz: Yes. The proceeds of an insurance policy held by the insured on his or her life are included in the gross estate of the policyowner if he or she dies owning the policy. To avoid estate tax on these insurance proceeds, the owner may want to give the policy to an irrevocable trust or outright to the intended beneficiary(ies). But, under Section 2035, if the owner dies within three years of such a transfer, the death proceeds will be included in his or her taxable estate.

To avoid this problem, the policyowner could sell the policy and at some later date, gift the proceeds of the sale. Because valuable consideration has been received in the sale rather than a gratuitous transfer of the policy being made, the policy value in the form of the sale proceeds will be *immediately* excluded from the former policyowner's taxable estate without any three-year waiting period requirement. This approach can be especially valuable for an elderly or unhealthy policyowner whose death within three years is a significant possibility. By using this strategy, the policyowner can avoid having the effective value of the policy cut in half or more by federal and state estate and/or other death taxes.

Leimberg/Gibbons: How can a life settlement be used to enhance a client's control and access to policy cash values? In other words, can a life settlement be used to retain direct or indirect access to either the cash surrender value or FMV of the policy if higher?

Babitz: A typical irrevocable life insurance trust (ILIT) is designed to prevent inclusion of the death benefit in the insured's taxable estate. The cost of that exclusion is that the insured must irrevocably surrender access to the policy's value. By using a Delaware or Alaska situs trust for this purpose, however, the insured could—at least according to some authorities—exclude the policy from his

[15] The IRS could argue, however, that the existence of a market for the policy and the possibility of obtaining a higher price than the normal gift or estate tax value are evidence that the price paid was insufficient. That same reasoning might cause fiduciary concerns: "If the buyer could obtain more, then why weren't the trust—and its beneficiaries—entitled to the higher amount?" Is there a breach of fiduciary duty to the beneficiaries of the selling trust? See Zaritsky and Leimberg, *Tax Planning With Life Insurance* (800-950-1216); Leimberg, "Policies for Valuation of Life Insurance," 139 Tr. & Est. 46 (Mar. 2000); and Alexander and Gallo, "The Effect of the Secondary Market on the Valuation of Life Insurance Contracts," 14 Prob. & Prop. 53 (July/Aug. 2001).

gross estate yet still have indirect access to the policy during his lifetime (via distribution of the policy value by an independent trustee in its sole discretion for such reasons as financial or medical needs). Should the insured need access to the policy value, the trustee of such a Delaware or Alaska trust could sell the policy and distribute all or part of the sale proceeds back to the insured. This approach maintains maximum flexibility and access for the insured to the policy value during his lifetime while—according to some authorities—preventing estate tax inclusion of the death benefit.

As an alternative, the insured could establish a family limited partnership to purchase the life insurance. The insured would retain 99% of the partnership interests as limited partnership interests. Over time, the insured could either (1) gift limited partnership interests to children or other family members (or a trust for their benefit) at a valuation discount for lack of control and marketability to exclude a pro rata portion of the proceeds from his taxable estate, (2) sell the policy and distribute the sale proceeds to himself or pro rata to the partners according to their interests at that time, or (3) retain all or most of the limited partnership interests to maintain control over and access to the policy for the rest of his life and then allow his estate to take a discount for the underlying death benefit paid to the partnership based on his estate's holding of limited partnership interests.

Leimberg/Gibbons: Explain how a lifetime sale of a policy might actually enhance the leverage of a life insurance trust.

Babitz: ILITs are often established to provide liquidity to pay estate taxes so that illiquid assets needn't be sold (perhaps at a deep discount) within the nine-month period following death when the estate tax is due. In many cases, the illiquid asset that is being protected is a closely held or family business interest.

One way to enhance the benefit of such a life insurance trust for business owners could be to have the trustee of the ILIT sell the policy and receive the proceeds while the insured-business owner is still alive.[16] The trustee could then purchase an equivalent amount of stock in the business. As long as the amount of stock purchased is a minority interest and/or is nonvoting stock, a substantial discount in value may be taken under currently accepted estate and gift tax principles. Accordingly, it is possible that more stock could be acquired with the proceeds than its pro rata value in the overall business. In addition, future growth of the stock purchased by the trust would be removed from the business owner's taxable estate.

Business planning

Leimberg/Gibbons: Does a lifetime sale of life insurance have a place in business succession planning?

Babitz: Owners of closely held businesses often establish buy-sell agreements under which the owners agree to purchase the interest of another owner upon his or her death.[17] These agreements are typically funded with cross-owned life insurance policies whereby one owner owns an insurance policy on the other owner's life and vice versa. If one owner dies, the surviving owner will have the cash necessary to purchase the interest of the deceased owner from his or her estate. Alternatively, the company may own the insurance policies and would use the death benefit to redeem the estate's interest in the business upon an owner's death.

The original reasons for acquiring these policies may have ceased to exist. For example, one of the company's original owners may have bought the interest of another original owner upon one's retirement or based on a mutual agreement to separate. Alternatively, a third party may have purchased the company.

In any of these scenarios, the original owners of the company or the company itself may no longer be obligated to purchase another owner's interest in the company at his or her death. Thus, the need to continue the life insurance policy may no longer exist. Receiving cash now by selling the policy or policies may therefore be advantageous.

Leimberg/Gibbons: The same reasoning should apply with respect to key employee coverage.

Babitz: That's correct. Companies will often purchase key employee insurance on certain employees' lives. Key employee insurance is acquired so that if the key person dies, the company can receive funds to absorb the economic shock, pay for the search for a replacement, and stabilize the company until the key employee can be replaced or compensate

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16 The insured's consent and active participation are needed when a third-party owner sells an existing policy to a viatical company. Authorization must be provided to obtain medical records, and post-sale contact with the insured must be allowed. If the insured is not under any obligation or has no incentive to participate, as a practical and legal matter, this option is not available.

17 See *The Corporate Buy-Sell Handbook* (610-924-0515).

for the loss of that employee's unique value.

But in some cases, usually many years after the acquisition of the policy, circumstances may have changed and the policy may no longer be needed. Through a lifetime sale, the policyowner can receive cash in exchange for that policy.

For example, John was a key salesman for ABC Widgets, Inc., who generated 50% of the company's revenues during 1993-1998. In 1995, ABC Widgets purchased an insurance policy on John's life with a death benefit of $2 million. John is now 70 years old and is planning to retire next year. The company no longer needs to insure John's life. Rather than letting the insurance policy lapse and receive no benefit, or surrendering the policy and receiving only its cash value, the policy may be sold in a life settlement and the owner may receive an amount significantly exceeding the policy's cash value.

Businesses as well as business owners and employees often own insurance policies on the lives of the owners and/or employees. These policies may have been purchased some time ago. At some point, the death benefit protection of these policies may no longer be needed by the business, business owner, or employee. The opportunity for the business to receive cash now for the existing policy may therefore be advantageous.

Conclusion

Leimberg/Gibbons: Can you tie this all up?

Babitz: Lifetime sales of existing life insurance policies, other than a lapse or surrender for cash value, may be useful in a number of circumstances. The recent increase in the number of providers funded by major financial institutions which are willing to to purchase policies will continue to enhance the potential economic benefits of lifetime settlements in appropriate situations.[18] It is essential that the entire estate planning team be aware of the possibilities for unlocking cash provided by such sales, and consider this technique as an alternative to a lapse, surrender, or retention of an existing life insurance contract.

Leimberg/Gibbons: Just as bankers rarely make loans to those who can't prove they don't need the money, insured individuals should consider that the more likely it is that a life settlement company will make an offer and the more it is willing to pay, the less it makes sense to sell or cash in the policy. In essence, the life settlement should be a last resort for those who qualify for it—because the requisite shortened life expectancy that triggers a meaningful offer is often also a clear indication that the insurance is a better investment in the insured's (or insured's family's or other beneficiary's) hands. And in many cases, a business that owns insurance it no longer needs will be better served in the long run by selling the insurance at its FMV to the insured. (Also keep in mind that, since the insured must consent to a probing examination of his/her health history as a precondition of a sale of the policy by the employer firm to a life settlement company, such a sale may not be legally possible.)

Life settlements make the most sense where it is likely that, in spite of significant health impairment, the insured may live beyond the point where continuing to pay premiums is economically feasible—and the amount that will be eventually paid is exceeded by the overall (including time value of money) cost. An example is a universal life contract with little cash value or a term insurance contract—where the insured might die just after the term expires but not before having paid huge aggregate premiums. The life settlement company can afford to take this risk because of the pooling concept and the insured might be best off shifting that risk to such a company rather than retaining it. And before cashing in a policy or selling it, clients should explore alternatives. For example, where the policy is an economically sound investment, consider the use of dividends to purchase paid-up insurance, extended term coverage, or to reduce premiums.

One fact rarely disclosed about these transactions is that, just as the terms and conditions of and commissions on a private placement life contract can be negotiated when the amounts in question are very large, so may the amount or terms of the commission structure be negotiated.

Lastly, it is essential for planners to do exceptionally careful due diligence with respect to the economic strength and particularly the ethical reputation of the life settlement company. Consider that the source of funding for life settlements, once the contract is signed, has a vested interest in the insured's earliest possible demise (compared to the normal insurance company's vested interest in the insured's living longer than expected). You don't want to be in a contract with the Soprano family! ■

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[18] Leisher, "Life Settlement Strategies Needed for High-Net-Worth Clients," 139 Tr. & Est. 12 (Nov. 2000); Greenberg and Mayer, "Extracting Hidden Value from Unwanted Life Insurance Policies," 28 ETPL 434 (Sept. 2001); "Hidden Value in Unwanted Life Insurance Policies," 15 Mich. L. Weekly 36 (11/13/00).