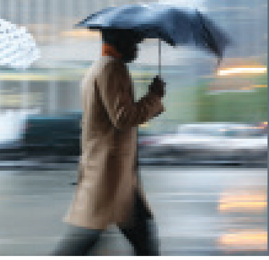


COMMITTEE REPORT:
INSURANCE

By **Jon B. Mendelsohn** & **Todd Steinberg**

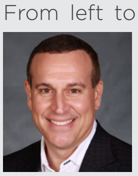
The Role of Life Settlements In Estate Planning

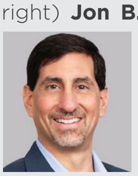
Capturing unrecognized value in insurance policies

Life insurance is a mainstay in estate and business succession/buy-sell planning. Despite its widespread use, however, many advisors and their clients focus on a policy's death benefits or current cash surrender value (CSV), rather than seeing the value of the life insurance policy as an investment asset with an existing fair market value (FMV). Through consideration of a life settlement, advisors and their clients can appropriately value and potentially monetize life insurance policies to solve immediate financial or non-tax planning needs. The life settlement option is particularly relevant when: (1) a client otherwise plans to discontinue paying premiums; (2) the policy's cash value is diminishing; and/or (3) the client outlives or no longer needs the insurance coverage for its intended planning purpose. Life settlements also can support exit strategies for underfunded (or poor performing) policies owned in irrevocable insurance trusts and other premium finance and split-dollar transactions. For more details on the reasons for considering life settlements, see "Sample Case Studies," p. x.

Clients expect their advisors to know and inform them of all desirable planning options, particularly if those options can provide them with additional current or future value. Understanding and advising on life settlement options can avoid difficult situations when clients, beneficiaries or family members subsequently learn of life settlements and ask critically if the option was explored before a policy cancellation or surrender. In addition, for policies owned by trusts or business entities, fiduciary liability (or the expense of defending an action) could apply to the failure to explore alternatives that may have provided substantially more value for the policy (and thus more available value for the trust beneficiaries or business owners). In addition, fiduciaries need to be prepared to justify why they did or didn't choose the life settlement option if beneficiaries later question that decision.

From left to right) **Jon B. Mendelsohn** is the chief executive officer of Ashar Group LLC in Orlando, Fla., and **Todd Steinberg** is a partner at Loeb & Loeb in Washington, D.C.



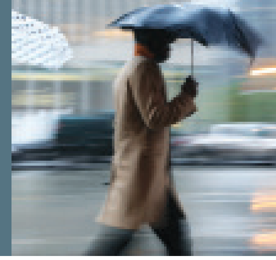


Life Settlement Basics

A life settlement is the regulated sale of a life insurance policy to a third party, institutional buyer for an amount greater than the policy's CSV but less than its current death benefit. After aggregating data, the process takes about two to four months and clients can stop it if they change their minds.

Who buys the policy? Life settlement buyers are institutional investors, like private equity firms, pension plans and reinsurers (that is, not individuals). These buyers purchase life insurance to create large portfolios of policies that act as a "non-correlated" investment to counterbalance the performance volatility of the equity and bond markets. In addition, unlike the unregulated viatical market of the 1990s, which served only terminally ill individuals (those expected to live less than two years), the institutional buyers in the current life settlement market are highly regulated.[1]

Why consider? Clients who are considering canceling their life insurance might look into life settlements as another alternative that might capture significantly more value than a surrender for net cash value. On average, a policy eligible for life settlement can have a value worth five-to-10 times more than its CSV. Further, unlike when issuing a policy, the



Sample Case Studies

Life settlements in action

June:

Her policy was underfunded and sitting in an irrevocable life insurance trust

When June and her husband purchased their policy, they were told they'd never have to make another premium payment. Her husband is deceased, and June is living longer than she ever expected. As her health declined, she was facing costly premiums and mounting medical bills. Her financial professional reviewed the value of all her assets, including her life insurance policy.

- **Female, age 84 with a change in health**
- **$1.5 million survivorship universal life, male deceased**
- **Cash surrender value = $25,000**
- **Life settlement value to seller = $475,000 (after 14 bids)**

Thomas and Katherine:

Their needs had changed and no longer needed the policy

Thomas and Katherine's children were grown with kids of their own and successful careers—changing the need of the policy. They were going to surrender their policy for the cash value and reallocate premiums into other areas of planning. Through a life settlement, they were able to uncover significantly more value and fund the retirement of their dreams.

- **Male, age 82 and female age 79**
- **$10 million survivorship guaranteed universal life**
- **Cash surrender value = $69,000**
- **Life settlement value to seller = $2.8 million (after 29 bids)**

James:

He sold his business, and his policy was no longer needed

Company-owned key man policy on a retiring business owner. Due to the costly conversion premium, the company planned to lapse the policy. The retiring business owner (James) negotiated for the policy ownership to be transferred to him. Afterward, his advisor suggested James have his life insurance policy asset appraised for secondary market value.

- **Male, age 75**
- **$5 million, 20-year convertible term**
- **Cash surrender value = $0**
- **Life settlement value to seller = $750,000 (after 18 bids)**

Maria:

Her family put off their own financial plans to care for her

Instead of focusing on their own retirement and family financial goals, Maria's adult children were funding her care giving needs. The life settlement created enough funds to pay for her care and eliminated the burdensome premium payments. Her children were happy they could fund care for their mother and focus on their long-term financial goals.

- **Female, age 80**
- **$500,000 guaranteed universal life**
- **Cash surrender value = $6,000**
- **Life settlement value to seller = $197,000 (after 12 bids)**

— Jon B. Mendelsohn

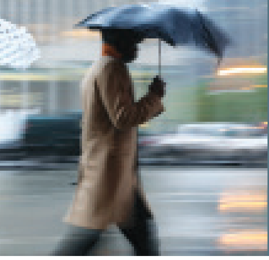
life settlement process isn't physically invasive for the insured, as there are no medical exams or blood tests required for any medical underwriting.

A client who could benefit from a current liquidity event can use a life settlement to minimize disruptions to other savings or equity investments and/or free up cash flow that would otherwise be allocated to premium payments.

Three Threshold Questions

Clients should explore a life settlement for a policy when they can answer "yes" to the following three questions: (1) Is there a desire or need to end the life insurance death benefit coverage or tax-free build-up inside the policy? (2) Is the insured's projected life expectancy within acceptable parameters for life settlement buyers? and (3) Is the policy the kind that's eligible (that is, marketable) for a life settlement?

1. **Desire/need for policy exit.** The need or desire for maintaining life insurance coverage can change over time. For example, based on recent higher exemptions and the use of sophisticated transfer-tax planning, the client may no longer face the same estate tax exposure or estate liquidity needs. Alternatively, perhaps the client's cash flow is currently tied up in illiquid investments, and they want to explore short-term liquidity options. A current or expected change in the client's finances may make the policy too expensive to maintain, while changes in family composition (for example, death or divorce of a spouse) may

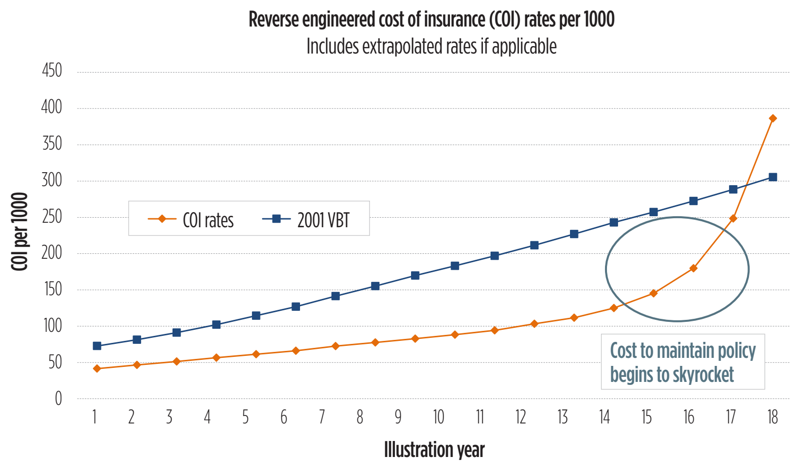


eliminate the original need for the death benefits. The insured also could be aging out of the desired coverage, meaning the premiums to maintain the policy will skyrocket if the client lives past a certain defined age. See "Aging Out of Coverage," p. x.

For businesses, life insurance originally acquired to fund the buy-sell of certain business interests may no longer be required due to an owner's retirement or a sale of the company. In the corporate context, life insurance coverage may have been acquired initially to secure certain bonding or repayment of debt obligations or representations and warranties in transactions and/or to fund deferred compensation. Over time, those original planning objectives cease to exist, and the parties assume they should simply stop paying premiums and cancel or surrender the underlying policies.

Aging Out of Coverage

When do premiums start to skyrocket?



— Jon B. Mendelsohn

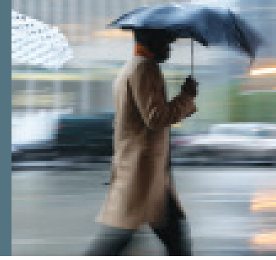
The projected longevity of the insured is a key factor in whether the policy will be marketable for a life settlement.

2. **Insured's longevity**. The projected longevity of the insured is a key factor in whether the policy will be marketable for a life settlement. Generally, life settlements involve policies that insure individuals in their 60s-to-90s with life expectancies of up to 15-to-18 years. An ideal insured has a policy issued with a "preferred" or "standard" risk rating but has since experienced a decline in health. This decline effectively creates a health arbitrage or mismatch, resulting in very inexpensive premiums for what life insurers would now consider a high risk insured (even if the insured's overall quality of life remains good, thanks to access to higher and better quality medical treatment that most wealthy individuals can afford).

3. **Policies eligible for life settlement**. Life settlements are available in all states and Washington, D.C. All types of policies can qualify, including term. Most buyers are looking for policies with death benefits of at least $100,000 to $100 million. Policies with low or no cash value are most commonly settled. Having a policy with a high cash value or loans may be detrimental to the valuation of the policy for life settlement purposes (leaving less net death benefit for the buyer).

Practically speaking, however, certain policy types and attributes will garner higher values in a life settlement:

- Universal life, including survivorship, is the most attractive category of policy purchased, including variable universal life policies and indexed universal life policies.
- Certain products will generate the most value, such as guaranteed universal life (GUL), as well as policies with riders, such as no-lapse guarantee (NLG) and return-of-premium. Pay special attention to GUL/NLG contracts as buyers will purchase policies without reviewing medical records. Buyers see these policies as safer long-



term investments, as there's almost no risk of carriers increasing the internal cost of insurance (mortality charges and expenses).

- Convertible term also can have value if the insured's life expectancy qualifies. Annual renewable term, however, typically doesn't have value, as the premiums can ladder up exponentially unless there's a low life expectancy prior to the escalating cost of the policy.
- Perhaps surprisingly, the least purchased policies have been whole life insurance contracts, as they typically have higher cash value and loans. For institutional buyers with billions to invest in maintaining the acquired policies, purchasing high cash value policies that result in a lower net death benefit isn't as attractive.

Insurance carrier ratings and behavior can also impact value. Highly rated carriers demand higher offers than carriers with lower ratings or those that have stopped issuing new life insurance policies.

Getting Started

Here are a few steps to get started:

Identify the policy. Wealth advisors should ask about life insurance policies in their initial intake conversations and/or include questions regarding life insurance and the insurance advisors in their discovery questionnaires. They should request a copy of the policy, recent annual statements and any available in-force illustrations.

They should ask the insured:

- To provide a description of the insured's health (does the insured have age-related health conditions, and are there any significant health changes or challenges currently)?
- Whether they need any assistance with their activities of daily living?
- What date was the policy last reviewed or independently appraised for fair market value (FMV)?

Confirm if policy is a candidate for life settlement. Confirm that the client can answer "yes" to the three threshold questions.

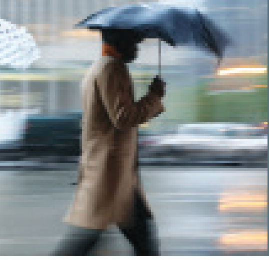
Consider whether to independently value the policy. If the client and policy meet the threshold criteria for a life settlement, then consider having the policy independently valued. The policy valuation provides the client with an estimate of how long the contract (policy) will last and the probability that the entire investment could be lost. While in-force illustrations are routinely sent on an annual basis, they're only one viewpoint on the valuation (or performance) of a policy. There are other alternatives in valuation and analysis, and clients and fiduciaries (particularly trustees of life insurance trusts) should be familiar with them and consider regularly their potential costs/use. At a minimum, clients, fiduciaries and advisors should understand the concepts and be sensitized to the "blind spots" in relying only on in-force illustrations.[2]

Brokers absorb all transactional, staffing and compliance costs during the process.

Accessing the Market

In life settlements, there are licensed sellers' representatives (life settlement brokers) with a fiduciary responsibility to the policy owner (seller) and licensed buyers' representatives with a fiduciary duty to the institutional investor (buyer). Each seller's representative and buyer's representative has a process to maximize the value received for those they represent. However, life settlements can be negotiated with or without a seller's representative.

Licensed life settlement brokers. Clients and their advisors can access the life settlement market by working with a licensed life settlement broker that has a fiduciary duty to the client/seller. Brokers provide an initial estimate as an alternative FMV data point of a policy. These brokers should have the valuation and longevity underwriting capabilities to review minimal information and then provide a responsible range of potential value. This can be an advantage to the client and advisors in determining whether to keep or sell the policy. Some brokers



maximize the gross price to the policy owner by using a policy auction that forces competitive bids from numerous independent buyers to generate the highest offer/value to the policy owner. Whatever the process, life settlement brokers are transparent with the policy owner/seller with respect to determination of the policy gross sales price, including disclosing the pricing analysis, longevity estimates and auction results. Brokers generate fees related to the total amount they're able to recover for the client. The higher the gross offer to the client, the higher the broker's fee. Note that brokers absorb all transactional, staffing and compliance costs during the process. Brokers also should be transparent on their fees and commission structure as the seller will only receive the net sales price for the policy. While we recognize most clients will focus on the net sales price received, many also desire and expect transparency regarding all fees, commissions and charges among the various advisors to the potential life settlement.

Clearly, efficiency and speed must have a cost associated in the outcome.

Direct buyers. Another option for accessing the life settlement market is through direct-to-consumer buyers, which may market on television and the Internet to purchase policies directly from clients. In recent years, these buyers have been further supported by lead generation companies that write blogs and have advertising websites to market and sell client information to life settlement companies for direct purchasing (avoiding competitive bidding). These direct buyers are licensed; however, they have a responsibility to generate the highest yield and return for their investors. As such, they don't represent the policy owner, and clients selling to direct buyers often don't have a separate life settlement representative or policy auction. While some sellers may prefer this direct and potentially quicker approach to immediate liquidity, these clients should understand that they won't know if their policy sold at the highest amount (gross or net). Clearly, efficiency and speed must have a cost associated in the outcome.

Questions to ask. When selecting which approach to take, clients and advisors should consider asking these questions of the life settlement broker or direct buyer:

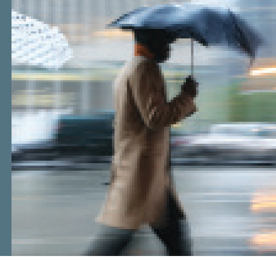
- How many states are you licensed in, and who do you legally represent in the process, the investor/buyer or the policy owner/seller?
- Do you facilitate a policy auction of independent buyers, or is your company the buyer or affiliated with the potential investor in any fee-sharing arrangements?
- Will you disclose your pricing analysis and all relevant life expectancy estimates?
- How do you generate revenue, and what's your fee structure? Do you earn more or less based on what your client receives?
- Has your company or its principals ever had any regulatory issues as a life settlement broker or buyer in the life settlement market? (Clients and advisors should consider independent verification, similar to when retaining other financial service professionals.)
- Are life settlements your primary business, or do you sell life insurance, manage assets, or other services?

Best practices. Have the client's tax advisors participate in the process from the outset to serve as a sounding board and to provide the client with the necessary protections and financial/tax advice. Be sensitive to the client and policy information disclosed before and during the life settlement process, including who's receiving the information (that is, seller's representative, buyer's representative) and how they may use it in valuing the policy and procuring bids/offers.

Policy Evaluation

The advisor and client will be asked to obtain the following minimal information for review to determine a projected range of values for the policy:

General life insurance information: This includes: (1) date of policy issuance, and (2) available policy



statements, illustrations and ledgers, including illustration with a level premium solving for $1,000 or less at age 105.

- **Longevity/health-related**: Completed medical questionnaire listing health conditions and medications.

The advisor and client will all need to gather more detailed information to generate a more precise range of values, including:

- **Medical records:** Health records could be gathered from the primary physician and certain specialists.
- **Updated policy information:** Review the policy copy and request any updated information from the life insurance carrier.

Impact of Life Expectancy

The estimate of the insured's life expectancy is the primary factor influencing the value of life settlement offers, as illustrated in "Calculating Life Settlement Offer," p. x.

The lower the life expectancy and/or the lower the premiums, the higher the offer and vice versa.

The amount and duration of the premiums needed to support a policy's death benefit post-life settlement also will significantly impact policy value. Unless the insured has a significantly reduced projected life expectancy, buyers will rarely pay more than 50% of the future death benefit in premiums (mortality charges and expenses) in addition to the lump sum paid to buy the policy from the original owner.

The lower the life expectancy and/or the lower the premiums, the higher the offer and vice versa.

Calculating Life Settlement Offer

Insured's expectancy is key

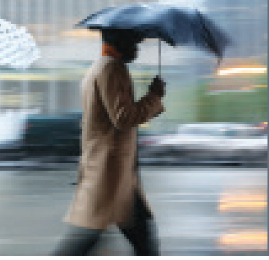
	Male Insured #1	Male Insured #2
Age	78	
Policy type	Universal life	
Death benefit	$1,000,000	
Annual premiums	$35,000 to age 105	
Cash surrender value	$25,000	
Projected actuarial life expectancy	12-14 years	6-7 years
Life settlement offer	$80,000	$400,000

— Jon B. Mendelsohn

Policy Auction

Policy auctions solicit competitive offers from multiple independent buyers with a goal of achieving the highest gross value for the policy. Keys to successful auction outcomes involve using a unified negotiation strategy, demonstrating consistency of messaging, control and exclusivity. These capabilities illustrate to buyers their need to sharpen their pencil and extend competitive bids and counterbids. "Place Your Bids," p. x, illustrates the amount of value that would have been realized by the buyer if the first bids would have been accepted. It's a real-life example of the range of value that buyers were willing to pay for the exact same policy after reviewing identical information. Note how Buyer 1 made the first initial offer and eventually the highest offer at the end of the auction, ensuring the client received the maximum gross value from the policy auction process. Through this competitive bidding with multiple buyers, the broker was able to secure for the seller a multiple of the first offer through the auction process.

If there's a policy auction, clients should be prepared to act quickly. Life settlement offers received typically have expiration dates of three to five business days. Following acceptance of the offer, the policy owner will execute closing documents



Place Your Bids

Get maximum gross value from the auction process

Death benefit: $1 million | female, age 76 | policy type: guaranteed universal life | cash surrender value: $5,000 | high offer: $370,000 (16 bids)

BIDS	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Buyer 1	$32,000							SAME BUYER								$370,000
Buyer 2	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline
Buyer 3		$100,000			$150,000								$330,000			
Buyer 4						$175,000			$300,000					$345,000		
Buyer 5	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline
Buyer 6			$115,000													
Buyer 7							$200,000					$325,000			$360,000	
Buyer 8								$215,000		$310,000						
Buyer 9	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline
Buyer 10	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline
Buyer 11											$315,000					
Buyer 12				$125,000												
Buyer 13	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline	Decline

— Jon B. Mendelsohn

with all required representations, warranties and disclosures based on applicable state insurance department requirements. On average, policy sellers have a 15-day rescission period, similar to a free look in life insurance, to unwind the transaction.

Consult tax advisors in the financial and tax analysis of any life settlement.

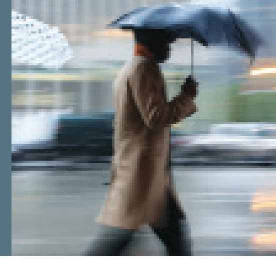
Taxation and Reporting

Taxation. Clients, as policy sellers, are subject to tax on any gain received from a life settlement that exceeds the total premiums they have paid for the policy (that is, their tax basis):[3]

- No tax on settlement proceeds up to tax basis (total premiums paid on policy).
- Ordinary income tax on the proceeds that exceed tax basis, up to the policy's CSV (but most life settlement policies have very little cash value).
- Long-term capital gains tax on any proceeds in excess of CSV.

Note that, if the policy seller is a grantor trust for federal income tax purposes, any taxes will be paid by the trust grantor at their personal income tax rates. If the seller is a non-grantor trust, the tax issues are more complex, as the taxes will be paid by such non-grantor trust at potentially higher (compressed) marginal rates. Consult tax advisors in the financial and tax analysis of any life settlement.

Information reporting.[4] The policy buyer must report the policy sale on Form 1099-LS (Reportable Life Insurance Sale) and file it with the Internal Revenue Service, as well as provide a copy to the life insurance carrier and the policy seller. The insurance carrier also must prepare and file Form 1099-SB (Seller's Investment in Life Insurance Contract) with the IRS and provide a copy to the policy seller. These forms will inform the IRS of the settlement price for the policy, as well as the seller's tax basis in the policy.



Trustee Considerations

Most policies in life insurance trusts haven't been adequately reviewed or independently valued since acquisition. Frequently, the trustee "inherits" the structure or design and implementation of the life insurance acquisition.

Trustees should proactively analyze the life insurance in the context of: (1) understanding both the future costs and expenses to maintain the policy and the anticipated cash flow/trust assets available to cover such costs versus; and (2) the ability to create a more marketable and liquid investment based on current needs and objectives. The consideration of an independent policy valuation or life settlement may provide the desired support for a trustee when highlighting the need for current and future additional premiums in excess of expectations because of past underfunding of premiums, poor policy performance, increasing charges and expenses and/or financing costs that have (or will with rising interest rates) become too costly. Proactive trustees also will be better prepared to assess and move forward with potential alternatives to maintaining a policy through ongoing premium payments and/or use of policy cash value and investment returns inside the policy.

Clearly, a life settlement might be a viable alternative when the insured has outlived all original premium funding strategies or the insured and beneficiaries refuse or are unable to make future gifts or transfers to support required premiums. The risk of a policy simply lapsing is a tragic outcome for all involved, but particularly for a trustee. A life settlement also may allow the trust to receive a much-needed cash infusion that could be used to fund a second (perhaps more viable) policy on the same insured for future benefit to the family. At a minimum, the consideration of a life settlement (as opposed to mere policy surrender or termination) protects the trustee from inevitable second-guessing by beneficiaries or their advisors.

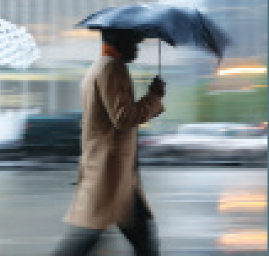
When a trustee is selling a policy, they should exercise due diligence before consummating any sale about the needs and objectives of the insured and, most importantly, the trust beneficiaries. Independent individual or corporate trustees should be careful to model and analyze all relevant tax implications of any potential sale, including the after-tax proceeds the seller will receive and invest compared to the premiums required to maintain the policy for the potential future income tax free death benefits. Fiduciaries should engage adult trust beneficiaries (and possibly their advisors) in the decision-making process and the review of the life settlement transaction versus other financial and investment alternatives to maintain insurance coverage. The trustee may need to obtain waivers and releases from trust beneficiaries before deciding to sell or after considering a trust settlement and deciding to keep the policy.

> Insurance trusts created by certain high-net-worth clients are also more likely than others to be involved in split dollar arrangements or other premium finance arrangements.

Split-Dollar Arrangements

Insurance trusts created by certain high-net-worth clients also are more likely than others to be involved in split-dollar arrangements (SDAs) or other premium finance arrangements. These SDAs may not be performing as anticipated (because of continued low credited interest rates, among other reasons) and may be at risk or in jeopardy unless the client makes significant cash gifts or loans to the trust for the foreseeable future to cover required debt service on third-party financing, premium shortfalls or "excess funding" to overcome poor investment returns/performance. In more positive situations, perhaps the future death benefit is no longer needed because of other successful wealth transfer tax planning or access to new liquidity.

If feasible, given the status of the insured and the policy, a life settlement of a trust policy could provide immediate cash to repay the SDA or premium



financing arrangement. Such cash infusion also may provide the financial support for required premiums on any other life insurance coverage held in the trust without requiring further cash gifts from the client. In some cases, the life settlement could even leave the insurance trust with a residual amount of cash post-rollout that wouldn't be includible in the client's estate and could be used for other current trust expenses/distributions.

Most importantly of all, as a fiduciary to your client and a paid advisor, always disclose all available options,

Takeaways

Estate-planning attorneys and wealth advisors should consider these takeaways when advising clients regarding life settlements:

Never cancel, surrender, transfer or lapse a policy without first having it independently appraised and/or valued for a potential life settlement.

A life settlement is an asset sale, not a traditional life insurance transaction. It just happens to be a life insurance policy being valued or sold.

Before providing any information to a life settlement company, ask whom they're licensed to represent—the policy owner or the investor. Understand the applicable fee structure and commission arrangements, while recognizing the risks to the maximum sales price from any "hidden fees" and undisclosed fee sharing with brokers or buyers. Understand the potential range of value between a policy auction versus no auction (with the desired goal to maximize the highest value for the policy). Appreciate the difference between gross and net sales price.

Life settlements are a reverse underwriting exercise so be as transparent as you can about the health conditions of the insured. Disclose if the insured needs assistance or has a variety of doctors. Still be mindful to whom and why you're disclosing such personal information (broker that represents the seller vs. direct buyer/investor).

Protect your advantage in the potential transaction. Encourage a seller representative to facilitate a policy auction to ensure the client's best interests always come first. You would never see a head coach walk over and hand their playbook over to the team on the other side.

Most importantly of all, as a fiduciary to your client and a paid advisor, whether you believe the client should maintain, surrender or sell the policy, always disclose all available options, including a potential life settlement, and document your file and your financial and tax analysis that supports your recommendations accordingly.

Endnotes

1. Life settlements are available in all states, including the District of Columbia, and specifically regulated in 44 states. Currently only Alabama, Hawaii, Missouri, South Carolina, South Dakota and Wyoming haven't passed specific life settlement regulations. Policy owners can still sell their policies in these states; however, they're subject to insurance regulation by their state insurance departments.
2. Some insurance contracts, such as guaranteed universal life or policies with no-lapse guarantee riders, have much less variability and are less dependent on future policy performance to offset future premiums, mortality charges and expenses at current or guaranteed rates.
3. *See* Revenue Ruling 2009-13. A life settlement can also create a long-term capital loss, if the policy doesn't have a cash surrender value, and the settlement proceeds received by the client are less than the client's tax basis in the policy (*see* Rev. Rul. 2020-05).
4. *See* Internal Revenue Code Section 6050Y.