



An Accountancy Corporation

Before Canceling a Life Insurance Policy Consider a Life Settlement – It Could Mean Big Bucks

Life settlements have become popular over the past few years and for a good reason. Given the right circumstances, they can significantly increase the value of an unwanted policy.

A life settlement is a sale of a life insurance policy by the policy owner to a settlement company that buys policies (these companies are called life or viatical settlement companies). They evolved from the concept of viatical settlements for terminally ill AIDS victims. However, more recently, life settlements are not being completed for terminally ill individuals, but rather for individuals over 65 who have some health problems.

The ideal candidate for a life settlement is an insured individual over the age of 65 who no longer wants, needs, or can afford his life insurance policy and who has experienced a significant decline in health (but not a terminal or chronic illness) since he bought his policy. This is the type of policy likely to be of value to life settlement companies as the premiums (based on the life expectancy before the decline in health) are relatively low compared to the expected payoff using the owner's now shorter life expectancy.

A number of situations should trigger consideration of a life settlement, including the following:

- A key person retires and key person insurance is no longer needed.
- A business is sold and buy-sell life insurance is no longer needed.
- Real estate is sold and life insurance bought for estate liquidity is no longer needed.
- Term insurance is becoming expensive as a client gets older.
- An old universal or whole life policy is becoming too expensive to maintain.

While a life settlement can significantly increase the value of an unwanted policy, the tax effect can also be substantial. Basically, the proceeds of a life settlement are taxable to the insured to the extent they exceed the insured's basis in the policy (IRC Sec. 72). In the case of a whole life policy, the income will usually be a combination of ordinary and capital gain. Sale proceeds equal to the cash surrender value less the insured's tax basis in the policy (generally, premiums paid less tax-free withdrawals) are recognized as ordinary income (Estate of Crocker; Gallun; Phillips). Any sales proceeds in excess of the policy's cash surrender value should result in a capital gain (Reingold).

Note: The life settlement company will have to report the death proceeds as income to the extent they exceed basis. The income tax exemption for the death benefit is lost because the policy was sold for value.

Life settlements are growing rapidly as a tool to generate significantly greater value from a client's life insurance policies. Helping our clients identify and cash in on these opportunities will result in a very happy client and that is always good for business.

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