

The Estate Planning Advisor

Life Settlements – Liquidating Unneeded Life Insurance

By Richard J. Shapiro, J.D.

People buy life insurance for income replacement, as part of a business buy-sell agreement, for estate tax protection, and for a variety of other reasons. However, when circumstances change, a policy may no longer be needed. Typically, unneeded policies are surrendered to the insurance carrier in exchange for its cash value. Given the right set of facts, there may be a better option: the “Life Settlement.”

A Life Settlement is simply the sale of a life insurance policy to a third party purchasing company. While most Life Settlements involve the sale of Universal Life or similar “permanent” policies, some term policies may qualify.

Why might a Life Settlement be a better option than surrendering the policy for its cash value? For marketable policies, a Life Settlement will provide a significantly higher payout than a surrendering the policy for cash value, and will likely have more favorable income tax consequences to boot. The Life Settlement payment will be higher than the cash value, because the policy is sold for its fair market value as determined at the time of sale. When a sale is contemplated, the insured’s medical information is provided to the purchasing companies that are considering making an offer for the policy. If, as a consequence of his or her declining health, the insured is unlikely to live to his or her actuarial life expectancy -- but is not terminally ill -- the purchasing company will be willing to pay more for the policy than merely its cash value. This higher value results because (i) it is likely that the purchaser will collect the death benefit before the insured’s actual life expectancy, (ii) the purchaser will have to continue paying the premiums for fewer years, and (iii) there will likely be other proposed purchasers competing for the right to purchase the policy, thereby driving up the price.

In contrast, the cash surrender value for the policy will be lower – often substantially lower – because that value is based on medical underwriting established at the time the policy was written, often years if not decades prior to the proposed sale.

If this is such a good deal, why haven’t you heard about this before? For one thing, Life Settlements are a fairly new planning strategy, and the concept is just beginning to gain traction. In addition, purchasing companies will only be interested in policies with a minimum death benefit of \$250,000, and the average value of a policy sold in the present marketplace has a death benefit of \$1,800,000.

That being said, if you have a large policy with an insured who has some health concerns but is not terminally ill, a Life Settlement is well worth exploring.

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