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Selling Life Insurance Policies in a Viatical or Life Settlement: A Cautionary Note

by
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In the last 15 years, a sort of reverse life insurance industry has come into being that profits from the premature death of insureds. This business promotes the sale of life insurance policies by those with terminal illnesses or impaired health for more than the policies' current values but at discounts below the death benefits that these policies would provide. Policyowners who sell out receive a cash benefit before they die that exceeds any cash value in the policies. Those who purchase these policies benefit if the insured dies, as anticipated, at or before the life expectancy upon which the purchase price of the policy was based.

This business grew out of the AIDS epidemic of the 1980's. Owners of relatively small policies with terminal illnesses found a means, through "viatical" companies, to sell their policies at a discount to the death benefits in order to receive immediate cash for medical and other expenses. Because of the shortened life expectancy of these insureds, viatical companies pay much more than the cash surrender value of a permanent insurance policy. They will even buy term insurance policies for a substantial percentage of the death benefit where such policies would otherwise only be valued at the amount of the unused premium for the particular premium payment period.

Viatical settlements provide a useful service in certain select circumstances when policyowners have no other way of producing needed cash while they are living and viatical companies pay amounts close to the full death benefit. However, viatical settlements on AIDS patients are less generous currently than they were originally because the average life span of these individuals has lengthened considerably with the introduction of more effective drugs.

Life Settlements vs. Viatical Settlements: Partially for this reason, the focus on viatical settlements has shifted to the larger and more rapidly growing business of "life settlements." While viatical settlements generally involve small life policies of $100,000 or less on those suffering a terminal illness (i.e., life expectancy is less than two years), life settlements entail the sale of policies of $500,000 or more on insureds over age 65.

To receive a price for their policies that exceeds the generally accepted valuation methods for life insurance policies, these insureds will generally need to have experienced deteriorated health since the policy was issued, but not so severely that they have a terminal illness. Life

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expectancy, as determined by the medical underwriters of these life settlement companies, will usually be 12 years or less, or at least several years short of normal life expectancy.

Because of the longer life expectancies with life settlements in comparison with viatical settlements, the percentage of the policy death benefit offered for a life settlement is much lower than with the viatical settlements of the terminally ill. Percentage payouts may be as low as 5% in some life settlement situations and 80% or more with some viatical settlements.

Whatever the percentage, in most cases, the sale of a life insurance policy where the insured has a reduced life expectancy should be a last resort and should only proceed after an independent analysis of the policy's value and an objective evaluation of the alternatives. Those intrigued by the possibility of selling a life insurance policy should first review a range of possible alternatives.

Alternatives to Policy Sales: Those in the business of buying insurance policies of the terminally ill and health impaired expect to make significant returns through the early death of the insured. A life insurance policy is a form of an investment by the current policyowner, just as it is in the hands of someone who might buy it. This is true whether the owner is an insured, a trust, one or more other family members, or a business. If an insured will likely (or inevitably) die sooner than was anticipated by the insurance company when the policy was issued, the policy becomes a better "investment."

It is preferable that current policyowners and their beneficiaries should gain the benefit of their policy "investments" in the unfortunate situations where illness or other impaired health has reduced the insured's life expectancy. They should therefore avoid selling their polices and should reap the benefits themselves, provided the following certain basic conditions apply. First, there should either be no compelling need for the cash that a policy sale would provide, or, at least, there should be an alternative source for the desired liquidity. Second, there should either be no risk that the policy will expire (and thus pay no benefit) before the insured dies, or the policyowner needs to be willing and able to incur whatever risk of this kind does exist. Whether or not the policyowner needs cash from the existing policy, consider these alternatives.

1. Do Nothing; Keep Policy in Force with Current Premium Payments: Assuming the policyowner does not need the cash liquidity from a policy sale, and the insured has experienced declining health since the time the policy was purchased, the policyowner should, if possible, keep the policy in force long enough that it will last until the insured's death. Paying additional premiums for whole life and similar policies may also increase the death benefit in years leading up to the insured's death, further enhancing the returns from the insurance "investment."

2. Keep Policy in Force with Current Death Benefit but Reduce Cash Outlay: Where the death of the insured is easy to predict within a certain period of time, even if not within the next year or two, it may be possible to reduce or even stop the current cash flow outlay for premiums without jeopardizing the death benefit. This is possible with a universal life policy, as it requires no regular, periodic premium payment if the account value of the policy is sufficient to sustain it. With non-forfeiture options on a whole life policy, "extended term insurance" could be elected to carry the policy to the insured's life expectancy. In various other ways, it may be possible to reduce or even eliminate current premium payments without substantially risking the loss of current coverage before the insured's death.

3. Borrow Money – from the Policy or Otherwise: If the policyowner needs cash, it is

possible to borrow or otherwise withdraw money from a permanent insurance policy. A partial withdrawal from the account value of a universal life policy is one possibility. A withdrawal cannot be taken from a whole life policy without lowering the death benefit, but borrowing the cash value is an alternative. Because interest payments on life insurance policy loans are, for the most part, no longer deductible, the policyowner should borrow against a residence, if possible (mortgage or home equity loan interest is deductible), before resorting to a loan from a life insurance policy.

4. Access Money from Accelerated Death Benefit Rider: Many policies now have a provision that permits insureds to receive a certain percentage of the death benefit if they are terminally ill. This can provide a ready source of cash that avoids the need for the sale of a policy in a viatical settlement. As with life insurance death benefits, the proceeds are received free of income taxes. Because of the terminal illness requirement (generally meaning a life expectancy of two years or less), access to "accelerated death benefits" is not an option for those who are not terminally ill but who have merely experienced a health impairment since a policy was issued.

5. Reduce the Policy Death Benefit if Possible and Necessary: Reducing a policy's death benefit, where that is possible, to make the policy affordable and sustainable for the insured's remaining life expectancy is preferable to selling the policy for a price well below the reduced death benefit. With a whole life policy, for example, the owner can elect a "paid-up" option with a reduced death benefit and no future premiums. The death benefit of that policy, while considerably below the prior level, may greatly exceed the price available in a life settlement transaction.

In some cases, the reduction of a policy's death benefit will make cash available from an existing policy without a loan and, perhaps also, without taxation. Again, for example, with a whole life policy where the dividends have been used to buy additional insurance ("paid-up additions") on top of the original face amount, that additional insurance can be surrendered, releasing a portion of the cash value to the policyowner. If the amount of the cash value received does not exceed the premiums paid, there will be no tax consequence.

Tax Considerations: Borrowing to the extent necessary and possible to raise cash, rather than selling a policy, is also preferable for tax reasons. While the proceeds from a policy sale in a viatical settlement are income tax-free, the sales price of a life settlement is not. The price received exceeding the owner's "basis" in the policy (premiums paid less amounts borrowed and unpaid interest) will be taxed. The IRS maintains that this entire amount is taxed as ordinary income, though some would argue that the portion of the policy sales price exceeding the value of the policy determined according to traditional rules should be taxed as a capital gain.

For example, if a policy with a basis of $150,000 and a cash value of $250,000 sells for $400,000 (assume that the cash value is the value of the policy as traditionally measured), the IRS would argue that the full sales price in excess of basis should be taxed as ordinary income. At best, the $100,000 difference between the cash value and the policy basis would be taxed as ordinary income and the additional $150,000 amount would be taxed as capital gain. At the same time, assume that the death benefit is $750,000. If the policyowner can maintain the policy until the insured dies, the beneficiaries will receive $750,000 tax-free. If, instead, the policy is sold for $400,000, the net benefit derived is not $400,000, but somewhere between $275,000 and $325,000, depending on tax rates and tax treatment.

In addition, the policy purchaser may be taxed on the eventual death proceeds of the policy in excess of the policy's purchase price. While life insurance death benefits normally receive tax-free treatment, this is not the case if the policy is sold. The "transfer-for-value" income tax rules govern the taxation of the death benefits of a policy that has been sold. In the above example, the difference between the policy purchase price of $400,000 (plus any subsequent premiums paid by

the policy purchaser) and the $750,000 death benefit would be subject to ordinary income taxation unless the buyer can qualify for one of the exceptions to the transfer for value rules. Assuming the policy purchaser cannot avoid taxation of the proceeds, the amount for which a buyer will purchase a policy will be diminished accordingly, and the possible policy sale will be an even less attractive proposition for the potential seller.

Exception for Policies that Might Expire: Having advised the avoidance of policy sales if possible, it should be noted that there are circumstances where even the policyowner who is not desperate for cash from a policy sale may not want to absorb the risk that the policy might terminate before the insured dies. In these situations, it may be preferable and safer to accept some value for the policy through a sale rather than risk ending up with no value. The policies most subject to these risks are term insurance and universal life policies that could expire or lapse before the insured dies.

With term insurance, the questions that should be asked by those owning a policy where the insured has a reduced life expectancy concern how long the term policy will last, the risk that the insured may not die within this period of time, whether the policy can be converted to permanent coverage of some kind, and, if so, whether the higher premiums required for this conversion are considered affordable.

With universal life and other policies that are designed to provide life-long insurance protection but which require sufficient premiums to maintain them, it is frequently the case that the cash value in these policies has not grown sufficiently, or has even shrunk, because of insufficient premium payments in the past. The questions to ask in these situations are similar to those involving term insurance. Initially, one would want to know how long the policy will likely last without additional premiums and then what additional premiums will be required to carry the policy, with reasonable confidence, beyond the point of the insured's diminished life expectancy. In many of these cases, because the additional required premiums may be considered unaffordable, or because of the uncertainty of the insured's life expectancy or the durability of the policy, a policy sale may be the preferable option.

Shop the Market: If a policy sale is seriously considered, it pays to shop the market. Estimates of the life expectancy of the health impaired vary considerably among underwriters. This variable is largely responsible for the wide discrepancies in the purchase prices offered for policies, especially with life settlements, given the longer and more uncertain life expectancies of these insureds.

Concerns for Investors: This article is intended to highlight the questions that insureds and policyowners should ask about the possibility of selling a life insurance policy in a viatical or life settlement. There are legitimate concerns as well for individual investors who may be solicited to participate in a pooled investment in these policies. These risks, including potential fraud in this nascent industry, are well addressed in other articles and books. [1]

The main point here is to urge the potential policy seller to go slow and explore other alternatives, to seek independent analytical advice, and to avoid the sale if possible except where there is a good chance that an existing policy will terminate or lapse before the insured dies.

[1] See www.viatical-expert.net and www.deathandtaxes.com/viatical.htm.

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Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois.