Life Settlements Can Be a Means for Charitable Giving

by Larry Simon and Gregory Schmitt, CLU

Agents and brokers typically use life settlements for their clients' retirement or long-term care needs, but many have yet to realize the benefits of using them to help clients support their favorite charities. U.S. charitable organizations are having a tough time fundraising, according to a report by the Foundation Center, a philanthropy clearinghouse. Many charities are cutting back on staffing and services or closing their doors entirely, in some cases, due to cuts in government funding, the slow growth in private contributions, and the amount of giving that is focused on responding to recent natural disasters.

Many charities keep their doors open, thanks to a volunteer base of seniors. Many of these seniors would also love to donate money, but don't want to dip into their life savings. Life settlements can provide an immediate supply of cash for charities that need capital sooner rather than later. Seniors who donate can benefit by turning an unneeded asset into a valuable gift and have the experience of giving the gift during their lifetime.

Tax Benefits of Donating Via a Life Settlement

Many high-net-worth seniors like to donate the proceeds from a highly appreciated asset to charity. They get a current income-tax deduction that is equal to the asset's fair-market value (the life settlement proceeds). If they donated the policy instead, they would only get a deduction that is equal to their lower-cost basis in the asset (premiums paid).

State and federal tax laws vary and IRS interpretations are subject to change. But, the general view is the proceeds from the sale of a life insurance policy may be subject to the following three categories of tax treatment:

1. No tax liability – settlement proceeds result in no tax liability, since it is a return-of-capital. This is to the extent that is equal to the owner's cost basis in the policy (sum of premiums paid by the policyholder)

2. Ordinary income is generated if the policy's cash-surrender value is greater than the cost basis above. The difference between the settlement proceeds (equal to the policy's cash-surrender value and the cost basis) is often treated as ordinary income, just as it would be if the policy were surrendered to the insurance carrier for its cash-surrender value.

3. Long-term capital gains – Since this is a capital asset, settlement proceeds in excess

of the cash-surrender value or the cost basis are treated as a long-term capital gain. (If cash-surrender value is less than basis)

Designating the charity as the recipient of part or all of the life settlement proceeds can give the donor additional gift options. If there is a taxable gain on the sale of the policy, the donor is eligible to receive an offsetting income-tax deduction for the gift. This reduces or even eliminates taxable gains and income on the policy sale.

The actual tax treatment may vary for any life settlement or any donation of proceeds from a life settlement. It sometimes depends on the health of the insured. Potential donors should always consult their tax advisors before making any decisions.

Life Settlements Alleviate the Complications and Expense of Donated Policies

Before life settlements, life insurance was often used as a deferred gift or as a means of wealth replacement for assets that were donated to a charity. Charities that received donated life insurance policies were burdened with administrative requirements, high premiums if the donor did not fund them properly, and a gift that could take years before providing a benefit. As a result, some of these organizations cashed in the policy for its surrender value, unknowingly sacrificing significant sums that could have been realized if the policy had been settled in the secondary market for life insurance.

Benefactors can get the maximum fair-market value for their policies and achieve their charitable objectives without causing expensive and complicated issues for their favorite charities.

There are many situations in which it is a good strategy to donate a life insurance policy to a charity. However, if neither the benefactor nor the charitable organization can meet the ongoing premium obligations of an unneeded life insurance policy, the insured can simply sell the policy in the secondary market – often for an amount that far exceeds the surrender value. The higher cash proceeds are then donated to charity. It also relieves the donor and the charity from ongoing administrative and funding requirements and allows for an immediate gift rather than a deferred gift.

How Life Settlements Work

With a life settlement, a policyholder sells the benefits of the policy to an investor, which is typically a large bank or other institutional investor. Most investors do not negotiate with policyholders directly. They provide financing for life settlement companies that negotiate pricing and compensation with a broker or agent. The broker or agent acts as the policy owner's fiduciary representative for the purposes of establishing a purchase price. As the contracting party, the life settlement company enters into an agreement with the policy owner for the sale of the policy. This company often manages post-settlement servicing of policies on behalf of the institutional investor, which becomes the new beneficiary.

A good candidate for a life settlement typically has $500,000 or more in universal life coverage. Any type of life insurance or irrevocable life insurance trust may qualify. The policy must have been issued two or more years previously, and in most cases, by an "A"-rated U.S. insurance company.

In addition, policies that life settlement companies consider for purchase must meet certain eligibility requirements including the following:

- The policy must be beyond any carrier or statutory contestability period, fully renewable, and subject only to the payment of premiums.
- The insured's life expectancy must be between 25 months and 168 months based on one or more medical evaluations from an approved evaluator.
- Term policies must have minimum term life insurance coverage equal to the greater of [more than?] two times the life expectancy or 10 years.
- The policy's face value cannot exceed $20 million.

Once a life settlement company locates an eligible life insurance policy and confirms that it meets initial eligibility requirements, the insured's medical records are sent to one or more medical evaluators for a life-expectancy rating. These evaluations and a policy illustration generated by the insurance company, which issued the policy are used to form the basis for a bid price, which meets investment criteria established by capital funding sources.

A policyholder who accepts the life settlement company's offer relinquishes ownership and beneficial interest in the policy in exchange for a cash payment. As the new policyholder, the investor must maintain all premium payments in order to keep the policy in force. The concept is much like the buying and selling mortgage contracts. In this instance, an insurance contract is bought and sold. The investor acquires the beneficial interest in the contract and the obligation to provide for servicing and administration of the contract.

Finding the Right Life Settlement Company

Agents and brokers should perform due diligence by gathering information from several competitive companies and targeting those with the most experience, the best resources, and the best reputation. They should find a firm with an excellent senior management team that has the most life settlement, life insurance, legal, and investment banking experience.

The following guidelines can help you make the right choice for your clients:

- Only solicit bids from experienced and ethical providers. Life settlement regulation is not the same in all states; some states do not regulate the industry at all.
- Choose a life settlement company that is licensed or otherwise qualified to do business in the state in which the policy holder lives.
- Look for proven industry experience, preferably at least $1 billion in purchased aggregate face value to date.
- Confirm that the company is institutionally funded and will not re-sell the contract to an individual investor.
- Check with the state attorney general's office or state insurance department for any complaints or legal actions against the settlement provider.
- Make sure your client consults with a professional tax adviser.

Life settlements will continue to grow and become more mainstream as a viable means of financial planning and charitable giving. At the same time, more agents, brokers, and financial planners will realize their fiduciary duty to disclose the benefits of life settlements to clients with unneeded policies. ❑

Larry Simon is director, CEO, and president of Life Settlement Solution Inc., based in San Diego. Gregory Schmitt, CLU is executive vice president and chief operations officer. Life Settlement Solutions and its management have purchased life insurance policies in excess of $1 billion aggregate face value to date. For more information, visit www.lss-corp.com.