Charitable Giving Through Life Settlements

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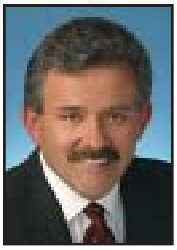

Agents and brokers often perform an estate-planning function, advising high-net-worth seniors who want to donate to their favorite charities. While many seniors want to include charities in the mix, they might not want or be able to tap into liquid assets to accomplish their philanthropic goals. Many donors have used life insurance as an effective strategy to magnify the effect of their contributions, and life insurance settlements can provide a significant enhancement to that strategy.

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Life settlements, also known as senior settlements, enable seniors to sell unneeded life insurance policies in a secondary market for an amount greater than the cash value offered by their insurance company but less than the death benefit. Life settlements give seniors access to funds they otherwise might have lost had they surrendered their policies or, worse yet, let them lapse — outcomes that occur with nearly 80% of universal life policies according to a June 2005 report by Bernstein Research and Milliman, an insurance consulting firm.

Though producers and brokers usually use life settlements as a means of restructuring life insurance programs, investing for retirement needs, or funding long-term care needs for their clients, many have yet to realize the benefits of using them as a tool for helping certain clients financially support charities.

Charities Often Need Cash Sooner Rather Than Later

According to the most recent report issued by Foundation Center, a New York clearinghouse for information on foundations and philanthropy, United States charitable organizations are having a tough time fundraising. Cuts in government funding, combined with slow growth in private contributions and the amount of giving in response to recent natural disasters, are forcing many charities to cut back on staffing and services and, in some cases, to close their doors entirely.

Many charities can keep their doors open thanks to a volunteer base often comprised of seniors who can

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bring a lifetime of experience to the organization. Many of these seniors also would love to donate money but don't want to dip into their life savings.

For charities needing capital sooner rather than later, life settlements can provide an immediate supply of cash. And seniors who choose to donate also benefit — they can turn an unneeded asset into a valuable gift and realize the generosity of the gift during their lifetime.

Tax Benefits of Donating Via a Life Settlement

With tax season around the corner, many high-net-worth seniors might find it beneficial to donate the proceeds from the sale of a highly appreciated asset to charity to get a current income-tax deduction equal to the asset's fair-market value (the life settlement proceeds) rather than their lower cost basis in the asset (premiums paid) if the policy were donated.

Although state and federal tax laws vary depending on individual circumstances and IRS interpretations are subject to change, the general view is that the proceeds from the sale of a life insurance policy may be subject to three categories of tax treatment:

1. No tax liability: Settlement proceeds, to the extent equal to the owner's cost basis in the policy (sum of premiums paid by the policyholder), result in no tax liability because they are a return of capital.

2. Ordinary income: This will be generated if the policy's surrender value is greater than the cost basis above. The difference between that portion of settlement proceeds equal to the policy's surrender value and cost basis often will be treated as ordinary income as it would if the policy were surrendered to the insurance carrier for its surrender value.

3. Long-term capital gains: Settlement proceeds in excess of the surrender value or the cost basis (if surrender value is less than basis) are treated as a long-term capital gain because this is a capital asset.

Donating to a charitable organization by designating the charity as the recipient of part or all of the proceeds from a life settlement can benefit the donor by providing additional gift options. If there is a taxable gain on the policy sale, the donor is eligible to receive an offsetting income-tax deduction for the gift, thereby reducing or even eliminating taxable gains and income on the policy sale.

The actual tax treatment of a life settlement or donation of proceeds from a life settlement might vary and sometimes depends on the insured's health. Potential donors always should consult their own professional tax advisers before making any decisions.

Life Settlements Alleviate Complications and Expenses Of Donated Policies

Before life settlements, life insurance often was used as a deferred gift or as a means of wealth replacement for assets that might have been donated to a charity. Charities that received donated life insurance policies were burdened with administrative requirements, high premiums if the donor did not properly fund them, and a gift that might take years before providing a benefit to the charity.

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As a result, some of these organizations often chose not to continue the policy but instead opted to cash the policy in for its surrender value, unknowingly costing the charity significant sums that could have been realized had the policy been settled in the secondary market for life insurance.

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In many situations, donating a life insurance policy to a charity is an effective strategy. If benefactors have an unneeded life insurance policy and neither they nor the charitable organization can meet the ongoing premium obligations, however, the insured simply can sell the policy in the secondary market, often for an amount far in excess of the surrender value than the benefactor or charity would receive from the insurance company.

The higher cash proceeds then are donated to charity. This allows for a higher cash donation than if the policy were surrendered, relieves the donor and the charity from ongoing administrative and funding requirements, and allows for an immediate rather than a deferred gift.

How Life Settlements Work

In a nutshell, the life settlement process works like this: A policyholder sells the benefits of the policy to an investor, usually a large bank or other institutional investor. Most investors do not directly negotiate with policyholders; rather, they provide financing for life settlement companies that will negotiate pricing and compensation with a broker or agent, who acts as the fiduciary representative of the policy owner for the purposes of establishing a purchase price.

The life settlement company is the contracting party that enters into an agreement with the policy owner for the sale of the policy and often is the company that manages post-settlement servicing of policies on behalf of the institutional investor who becomes the new beneficiary of the policy.

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

In addition, policies considered for purchase by life settlement companies must meet certain eligibility requirements, including:

• 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 and 168 months based on one or more medical evaluations from an approved evaluator;

• Term policies must have a minimum term life insurance coverage equal to the greater of two times the life expectancy or 10 years; and

• The face value of such policy cannot exceed $20 million.

After a life settlement company locates an eligible life insurance policy and confirms that initial eligibility requirements are met, the insured's medical records are sent to one or more medical evaluators for a life-expectancy rating.

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If an offer to purchase the policy will be extended to the owner, the results of these evaluations, along with the information derived from a policy illustration generated by the insurance company that issued the policy, serve as the basis for determining the bid price that will meet investment criteria as established by capital funding sources.

If a policyholder accepts the life settlement company's offer, he or she 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 to keep the policy in force. The concept is much like the buying and selling of mortgage contracts — in this instance, an insurance contract is bought and sold with the investor acquiring both the beneficial interest in the contract and the obligation to provide for servicing and administration of the contract.

The market opportunity exists primarily as an alternative to surrender values payable by life insurance companies when a policy owner decides to redeem or cash in the policy. These surrender values often are so low that a qualified life settlement provider company can pay a much higher value.

Finding the Right Life Settlement Company

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

In addition, these guidelines can help you make the right choice for your clients:

• Solicit bids only from providers that are both experienced and ethical. Regulation of life settlements is not the same in all states, and some states do not regulate the industry at all.

• Select a life settlement company that is licensed or otherwise qualified to do business in the state in which the policyholder resides.

• Look for proven industry experience, preferably at least $1 billion in purchased aggregate face value to date.

• Confirm the company is institutionally funded and will not resell the contract to an individual investor.

• Check with the state attorney general's office or state insurance department for any complaints or legal action against the settlement provider.

• Make sure your client consults with his or her professional tax adviser.

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

Larry Simon is director, CEO, and president of Life Settlement Solutions, Inc. Mr. Simon also has served as the CEO and a director of the Global Life companies since their formations in 1999 to 2001. From 1972 through 1999, Mr. Simon was active in the establishment and management of the operations of other successful business ventures. Earlier in his career, he spent about four years with Deloitte and Touche Tohmatsu as an auditor and consultant.

Gregory Schmitt, CLU, is executive vice president and chief operations officer of Life Settlement Solutions, Inc.. He joined Life Settlement Solutions in April 2004 after serving as territorial vice president for the Prudential Insurance Company of America. Mr. Schmitt worked for Prudential for 24 years, starting as a sales agent and rising through the ranks, ultimately being appointed as senior vice president for the Western Territory. Mr. Schmitt holds California residential insurance producer licenses as a life agent, variable contracts agent, and fire and casualty broker/agent. While employed by Prudential, he also was a registered representative and registered principal associated with Prudential's affiliated broker/dealer, Pruco Securities, LLC.

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