FEATURE Story

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Life settlements:
a growing new strategy in philanthropic giving

By Larry Simon and Gregory Schmitt

Many donors have used life insurance death benefits as an effective strategy to magnify their contributions to their favorite charities; however, life insurance settlements may provide a significant enhancement to that strategy. Life settlements, also known as viatical settlements, enable seniors to sell unneeded life insurance policies in a secondary market for an amount greater than the cash surrender value offered by their insurance companies.

As life settlements grow as a viable means of charitable giving, more financial planners will realize they have a fiduciary duty to their clients to disclose the benefits of life settlements.

Current state of regulation

To provide answers to client questions, it is imperative for financial planners to understand the regulation of the secondary market in their respective states, as these laws add credibility to the industry and protect the consumer.

According to a June 2005 Bernstein Research report titled *The Long View: 2005 edition – U.S. Perspectives*, the life settlement market has grown from zero in the mid-1990s to around $13 billion today. Bernstein Research projects the market will grow to $160 billion over the next several years. Along with this industry growth will come an increase in state and federal regulation of the secondary market for life insurance.

At present, 39 states have some form of regulation for viatical or life settlements, including minimum payouts (as a percentage of face value) in some states. According to the Bernstein report, approximately 15 states allow agents with standard life insurance licenses to negotiate life settlements. The authors of the Bernstein report contend the lack of licensing in other states does not prevent life settlements from taking place. Instead, "it could give rise to poor-quality transactions that may or may not benefit policyholders." Further, "another issue is whether underwriters need to be registered with insurance regulators, which again appears to vary by state."

For years, leaders in the life settlement industry have worked closely with the National Association of Insurance Commissioners to work for consistent regulation of life settlements. In 2004, the NAIC published a model regulation for viatical and life settlements, under which licensed life insurance agents would not be required to have a separate settlement broker's license. At the same time, the National Council of Insurance Legislators supported similar efforts to not require separate licenses.

The current version of the NAIC's Viatical Settlements Model Act broadens the definition of viaticals to include any sale of a life insurance policy, including life settlements. It also includes clauses protecting against fraud and gives states the option of addressing sales to investors. Legislation based on the model act is pending in California, Illinois and New York, among other states.

Tax benefits of a life settlement

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

- **No tax liability** – settlement proceeds, to the extent equal to the sum of premiums paid by the policyholder result in no tax liability, since they are a return of capital;
- **Ordinary income** – will be generated if the policy's cash-surrender value is greater than the cost basis defined above. This difference will often be treated as ordinary income, just as it would if the policy were surrendered to the insurance carrier; and
- **Long-term capital gains** – settlement proceeds in excess of the cash-surrender value or the cost basis are treated as a long-term capital gain, since this is a capital asset.

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, thereby reducing or even eliminating taxable gains and income on the policy sale.

Life settlement candidates

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 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:

- 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 14 years, based on medical evaluations;
- Term policies must have a minimum coverage equal to the greater of two times the life expectancy or 10 years; and
- Some settlement providers require that the face value of such a policy cannot exceed $20 million. **BN**

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