



The Secondary Market for Life Insurance

by Gary L. Miller

A number of years ago, a secondary market developed for terminally-ill individuals to sell their life insurance policies to “life settlement companies” for amounts somewhat less than the death benefits, but significantly more than the cash surrender values. Such sales, typically known as viatical settlements, are income tax-free in the same manner as post-death life insurance benefits, provided certain requirements are met.

In recent years, this secondary market for life insurance has expanded dramatically, and life settlement companies will often make offers for policies on the lives of reasonably healthy individuals, although offers will be more favorable for medically impaired insureds. Generally, the minimum age is 65 and the minimum policy size \$250,000. Life settlement offers can be obtained through brokers who, with the insured’s written authorization, obtain the insured’s medical information and forward it to a number of life settlement companies for review, then provide the resulting best offer or offers to the policyowner.

A life settlement may be a viable option for a policyowner who no longer needs the policy, who intends to discontinue the policy as unaffordable (perhaps because the policy is underfunded due to overly optimistic projected interest rates at the time of purchase), or who wishes to use the cash value to purchase new insurance. However, a policyowner considering a life settlement should always be mindful that, if the policy would provide a favorable rate of return at the insured’s death for the life settlement company, it will provide an even more favorable return for the current beneficiary. In addition, any gain on the policy (proceeds minus premiums paid) will be taxable. Therefore, even if the death benefit is no longer really needed by the beneficiary, the policyowner should always consider retaining the policy and increasing the funding to whatever level provides a comfortable margin of safety. But if the final decision is to surrender or lapse the policy, the policyowner should consider the option of a life settlement.

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A more aggressive use of the life settlement market is that often referred to as Stranger-Owner Life Insurance, or SOLI. SOLI involves the purchase of unneeded life insurance specifically for resale to life settlement companies after expiration of the two-year “incontestability period.” Often the arrangement is promoted as “free life insurance,” with premiums loaned to the policyowner rather than paid out-of-pocket. Such arrangements carry significant risks, including:

- Exhaustion of the insured’s unused insurance capacity so that new life insurance may be unavailable for legitimate needs in the future.
- Possible taxation of any incentive offered to buy the policy and/or the economic value of the insurance protection provided.
- Possible taxation of discharged indebtedness if the policy is turned over to the lender after two years.
- Possible taxation of the entire sale proceeds as ordinary income (in spite of promoters’ claims that the seller will have basis and that proceeds in excess of cash surrender value will be taxed as capital gain).
- Possible voiding of the death benefit during the first two years based on misrepresentation (e.g., a representation that purchase of the insurance is for family needs rather than for resale).
- Potential voiding of the death benefit after the first two years based on lack of “insurable interest” at policy inception, resulting in the insured’s estate possibly being drawn into expensive litigation and even becoming liable to the investor for the amount of the death benefit.
- Possible inability to sell the policy after the first two years, a risk becoming increasingly more likely because of significant regulatory and legislative activity (including proposed legislation in Ohio) aimed at banning or restricting such arrangements.
- The discomfort that may result from the insured’s awareness that strangers stand to benefit from his or her death.

Because of these risks, policy owners should enter into SOLI arrangements only with great caution and with competent legal advice. The sale of an existing policy in the secondary market, on the other hand, involves less risk and may be appropriate in some cases. But before proceeding, the policyowner should consider the advisability of retaining the policy, and, if a life settlement is the best alternative, have the proposed legal documents involved carefully reviewed, especially the policyowner’s representations, warranties, and potential liabilities.



For more information on sales of life insurance policies in the secondary market, Mr. Miller can be reached at our Toledo office by calling 419-241-6000. Mr. Miller is a member of the Firm and a former financial planner who practices in the areas of estate planning, probate, elder law, business law, taxation and qualified retirement plans.

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