Life Settlements

A life settlement is the sale of an existing life insurance policy to an investor. The seller receives cash. The buyer pays future premium and receives the insurance proceeds at the insured's death.

The sale proceeds range between the cash surrender value of the policy and its face amount. For example, an offer on a policy with a $1,000,000 death benefit and a $50,000 cash surrender value would be between those two numbers. The actual amount, however, is determined by a number of factors including life expectancy, the cost of future premiums and projected financial benchmarks (e.g., interest rates).

EXAMPLE

A 77 year-old man had a $3.9 million policy that was not performing up to expectations. His advisor recommended that the policy be appraised and the policy was valued at $740,000, four times its cash surrender value. The client decided to sell the policy and use the proceeds to fund new, more cost-efficient insurance. The new policy had a face value of $4.4 million and significantly lower ongoing premiums. Such life settlement cases are an everyday occurrence now that the secondary market for life insurance has transformed the financial planning landscape for high net worth individuals.

SUITABLE CANDIDATES

The client (individual or business) must currently have a policy which is no longer wanted or needed. This criterion may be met if (i) a new generation product is more efficient; (ii) the policyowner no longer wishes to pay premium; or (iii) the need for coverage no longer exists.

The life expectancy of the insured must be less than 15 years. This criterion can be met due to a change in the insured's health or simply the natural aging process.

TAX IMPLICATIONS

The sale of a life insurance policy may be a taxable event. Tax experts disagree on the details of taxation, but a commonly-held, though not authoritative, belief is:

- The portion up to the investment in the contract will be received tax free.
- The portion exceeding the investment in the contract, but not exceeding the cash surrender value, will be taxed as ordinary income.
- The portion exceeding the cash surrender value will be capital gain.