

WHITE PAPER

“Life Settlements: What CPAs Should Know”



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SETTLEMENTS, INC.

Life Settlements: What CPAs should know.

Life Settlement Defined

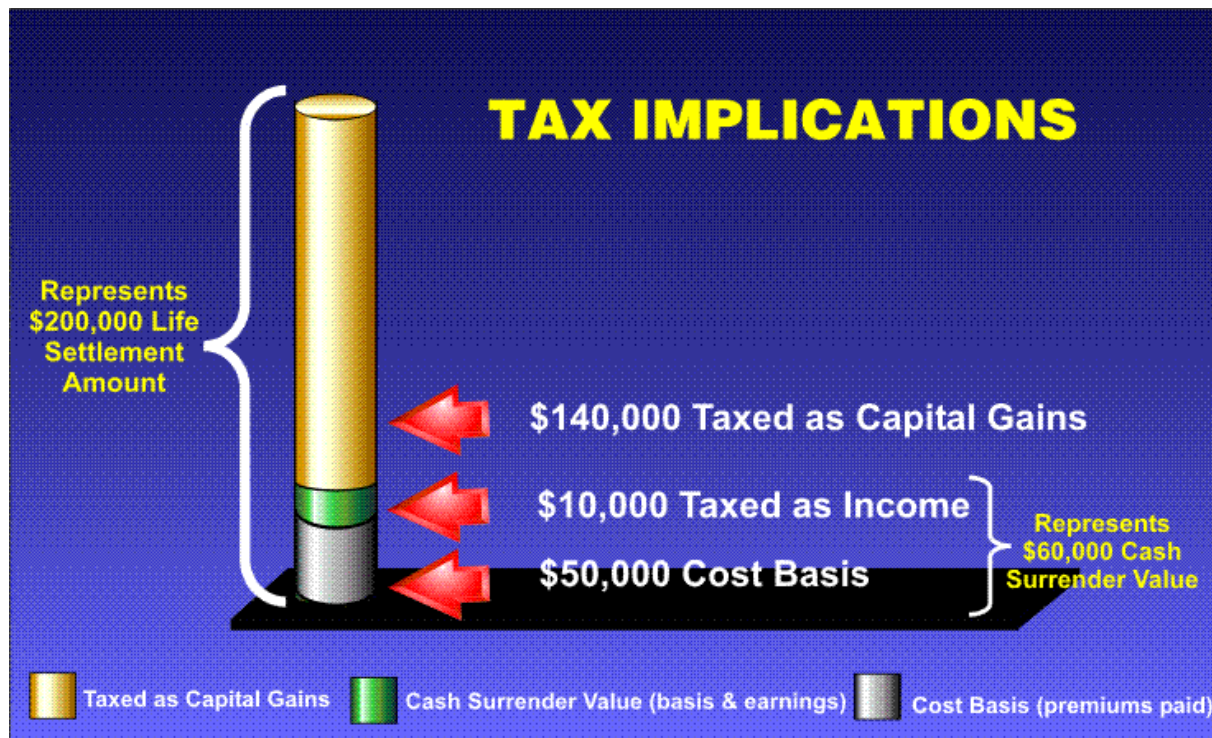
A life settlement is the sale of a life insurance policy in the secondary market – normally through a broker or financial planner – to a life settlement provider, also known as a “funder.” The transaction involves the policy owner’s transfer of ownership rights to the provider for an agreed amount. The settlement provider becomes responsible for premium payments to keep the policy in force. Upon the death of the policyholder, the provider retains the right to collect on the policy.

When to Consider a Life Settlement

CPAs and financial advisors can help their clients tap into “found money” that may be hidden in unneeded life insurance policies. At Advanced Settlements, Inc., we use the following criteria when working with producers and clients to obtain multiple offers for their policies: (1) The policyholder must have owned the life insurance policy for at least two years; (2) the policyholder must be at least 70 years of age and have a life expectancy of 12 years or less; (3) and have a policy with a minimum face value of \$250,000.

Tax Implications

In most cases, any amount paid for a policy in excess of the cash surrender value is treated as a capital gain. The following graph illustrates how the proceeds from a sale would be taxed on a policy with a total face value of \$1,000,000, a cash surrender value of \$60,000 and cumulative premiums of \$50,000. When considering this or any other financial planning option, clients are advised to consult their tax advisor.



Case Example No. 1

The proceeds from a Life Settlement are used to fund a more cost-effective life insurance policy.

Problem

This case involves an 82-year-old retired business owner who held two life insurance policies with death benefits totaling \$5 million. One policy was valued at \$2 million and the second was \$3 million – both of which would be payable to a trust upon his death. The plan administrator of the trust desired the same death benefit but wished to reduce the annual premiums totaling \$412,120.

Solution

The financial advisor who wrote the two original policies had recommended pursuing a life settlement and then using the proceeds from that settlement to fund a single \$5 million policy. The highest life settlement offer totaled \$900,000, which the agent recommended be rolled into a new policy. The result left the client with the same death benefit coverage of \$5 million, but now the premiums would be reduced to \$291,789 – for an annual savings of \$120,331 a year.

Case Example No. 2

The proceeds from a life settlement transaction are used to liquidate a corporate buy-sell agreement to help stabilize a corporation.

Problem

This specific case involves two elderly sisters who were major company shareholders. The two sisters owned a buy-sell agreement in order to maintain corporate stability in the event of their deaths. The company needed an infusion of cash to pay down debt, increase shareholder dividends and generally stabilize the corporation.

Solution

The older sister carried a \$1 million life insurance policy with a cash surrender value of \$7,297. The younger sister had a \$2 million policy with a cash surrender value of \$141,262. Their life insurance agent recommended a life settlement on each policy as the solution. In the end, the life settlement proceeds netted the older sister \$386,965 beyond the cash surrender value, and the life settlement netted the younger sister \$158,738 beyond the cash surrender value.

At the conclusion of the transaction, the corporation had a total of \$694,262 in “found money” that was used to address the company’s financial needs.

Note: Average payout is approximately 22% of the policy face value obtained by an owner in the last six months.

Industry Background

According to a study released in June 2003 by Conning Research & Consulting, Inc., life insurers' profit margins – which Conning points out are already under intense pressure due to lower investment returns – are now being squeezed further by the growth in the life settlement industry.

The recent rise in the industry has even caught the attention of overseas investors. As reported in the May 15, 2003 issue of the British business magazine *The Economist*, after savings accounts and government bonds, life insurance may be the most respectable of investments due to the new secondary market for life insurance policies. The magazine reports that life settlement firms bought \$2 billion-worth of policies (by face value) last year – ten times as much as they acquired in 1998 when the industry first started to emerge.

The secondary market was created by consumer demand – and as our aging population continues to soar and baby boomers begin reaching the life settlement threshold age of 65 – the industry will likely experience steady growth for the foreseeable future. Some estimate that the industry's potential – comprised of Americans over 65 years of age have life insurance coverage worth \$500 billion.

Regulatory efforts

In 1992, the National Association of Insurance Commissioners (NAIC), composed of the insurance commissioners of each of the fifty states, began the development of a model act for the regulation of the viatical settlements business. The result was the current Viatical Settlements Model Act, originally adopted in 1993. More than half the states have enacted statutes based on this Model Act.

At the present time, viatical and life settlements are governed by a patchwork of state and federal regulations. Currently, more than 20 states regulate life settlements, while approximately 36 states regulate viatical settlements.

Financial Advisors: Understanding their role

Financial advisors have a fiduciary responsibility to represent the seller's interests in a life settlement transaction when functioning as a financial services professional. The financial advisor should approach this responsibility with a methodology that includes the following four-step process:

1. Assess the client's overall financial picture to determine whether the life settlement is an option;
2. Perform an analysis of the client's probability for a life settlement
3. Perform due diligence by researching the marketplace for a reputable life settlement provider / broker who is backed by institutional funders;
4. Pursue the highest market value for the seller by insisting on multiple offers from the life settlement provider.

Assessing the client's financial picture

Assessing the client's overall financial status and exploring all current life insurance holdings is the first step in determining whether the life settlement is the appropriate course of action. Questions the financial advisor will want to explore during the assessment include:

- Does a client need new life insurance, annuities or long term care?
- Has the insured outlived beneficiaries?
- Have Insurance needs changed?
- Are the policy premiums now unaffordable?
- Are estate taxes changing?
- Has the insured's health status changed since policy inception?
- Is the insured a retiring key-man or selling a company/partnership?
- Is the policy owner planning to surrender or lapse a policy?
- Is a policy owner going through a bankruptcy?

Analyzing the probability

During the next phase of the assessment, the financial advisor will want to use a qualifying worksheet to determine a prospective client's life settlement probability. By using a worksheet using a point system for scoring, the financial advisor should gather and score data on the following criteria:

- Client age and sex
- Medical condition
- Policy type
- Current cash surrender value of the policy as a percentage of the death benefit
- Outstanding loans as a percentage of the death benefit
- Current premiums as a percentage of the death benefit

Moving forward

CPAs and other financial services professionals now have an additional estate planning tool to assist high net worth senior clients with money management. The proceeds from life settlements can be used for an unlimited number of financial planning needs.

For further information about Life Settlements and Advanced Settlements, call us at 1-800-561-4148.

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