DOES IT MAKE SENSE TO SELL YOUR LIFE INSURANCE POLICY?

By Peter Katt

Policy sellers beware: Life-settlement firms are pursuing their own financial interests, and have extensive pricing expertise to do so—an advantage that individual policyholders can't match when evaluating a possible sale.

"*Be your own beneficiary*" is the catch-phrase heading a life-settlement firm's Web site.

Life-settlement refers to the purchase of "unneeded" life insurance policies. Among the many symbols that will express the 21st century human condition, "be your own beneficiary" may become the defining statement for aging baby boomers (myself included), who started our run with "do your own thing."

Social commentary aside, this article will examine whether life-settlements are likely to be of value to you.

A recommendation that you sell your life insurance policy may not be as rare as you may think, if the past year is any evidence. In short, there seems to be something of a full-court-press on to convince affluent policyowners to wise up and "be your own beneficiary."

The reason behind this is that life-settlement firms claim their net return is 12% to 15%, and they are paying insurance salesmen and others willing to solicit such purchases 10% to 15% of the purchase price as a commission. Add to this the possible repeal of the estate tax making more policies available for purchase, and there may be more agents buying policies than selling them.

LIFE-SETTLEMENT PROFILE

There are three necessary characteristics that an insured person needs to have for a life-settlement firm to consider purchasing their life insurance policy:

- They need to be over the age of 65;
- They need to have a life expectancy of between two to 13 years; and
- They need to have had a significant decline in health since the policy was purchased, so that the policy underwriting rating is considerably better than the insured's current health.

If you don't fit this profile, it is simply a waste of time to go through the analysis with any solicitor.

Life-settlement firms and proponents always refer to the sale of life insurance policies that are "no longer needed." However, "needed" is not a particularly useful definition; many individuals have life insurance they don't need but that they "want."

"Needed" life insurance fulfills a risk management function such as having others financially dependent on an insured, as would be the case with a primary family income earner raising children.

"Needed" life insurance also is associated with estate planning—for example, a family wants their business retained but there aren't adequate resources to pay estate taxes without life insurance funding.

"Wanted" life insurance is an asset that can perform its objective more

Peter Katt, CFP, LIC, is sole proprietor of Katt & Co., a fee-only life insurance advisor located in Kalamazoo, Michigan (616/372-3497; www.peterkatt.com). His book, "The Life Insurance Fiasco: How to Avoid It," is available through the author.

effectively than alternatives, but doesn't have a risk management element. Often life insurance policies move from the needed to the wanted category as children become independent or a family business is sold. (I have made the case in previous articles that permanent life insurance is an excellent tax-deferred saving and investing asset, as well as an intergenerational wealth-transfer asset because of its unique income tax characteristics. See my *AAII Journal* columns "Passing on Your Wealth: Gift Planning and the Use of Life Insurance" [August 1996] and "Using Variable Life Insurance as an Investment Alternative" [July 2000], available at www.aaii.com or www.peterkatt.com.)

But whether life insurance is "needed" or "wanted" misses the point in the context of life-settlements that, by definition, only involve insureds who are in much worse health than when they bought their life insurance policies. The only reason that the life insurance secondary market exists is because certain life insurance policies have become much more valuable due to the insured's poor health—and those particular policies are anything but "unneeded."

Life-settlement firms readily point out that life-settlements almost always involve affluent policyholders who can continue paying life insurance premiums. And it is to this group that my valuation comments apply.

For those individuals who sell their policies because of their inability to continue paying premiums, selling their policy may be a rational choice.

THE TRANSACTION

To illustrate how these transactions work, here are the steps and factors involved in the purchase of a life insurance policy. In this example, the policyholder is over the age of 65, with a life expectancy of two to 13 years, and falls in a policy underwriting category (i.e., preferred, standard, etc.) that is much better than current health would warrant.

The transaction steps are:

- A detailed health history is obtained from the insured's doctors by the life-settlement firm and sent to reviewers to assign a life expectancy.
- Detailed information about the insurance policy structure and pricing is obtained by the life-settlement firm and analyzed.
- The policyholder's insurance company is required to have certain minimum financial strength ratings.
- Based on the life expectancy and policy pricing and structure, a purchase price is calculated by the life-settlement firm so that it can earn a return of 12% to 15%.
- Commissions of 10% to 15% of the purchase price are paid to the insurance salesman or other soliciting agent.
- The life-settlement firm, based on its life insurance pricing expertise, establishes the most cost-efficient premium structure based on the insured's life expectancy.
- When the policy is sold, the seller must pay taxes on the gain, although how the gain is treated is currently open to dispute. If a policy's cost basis is $650,000, the cash value is $750,000 and the life-settlement purchase price is $1,000,000, one possible tax result is the recognition of $350,000 as ordinary income (the difference between the sales proceeds and cost basis). However, some tax experts claim that only the difference between the cost basis and cash value, or $100,000 in this example, is ordinary income and the balance of $250,000 is capital gain. I don't believe the IRS has ruled on this yet so the capital gain treatment is not certain.
- When the insured dies, the life-settlement firm must recognize the life insurance proceeds less its cost basis as ordinary income.
- The insured appoints several agents to keep the life-settlement informed of their life and death status on a regular schedule.

Policy sellers beware: Make note of the very important fact that life-settlement firms do not independently evaluate possible purchases to determine which ones will and will not benefit policyowners. Life-settlement firms are pursuing their own financial interests, and have extensive pricing expertise to do so—an advantage that individual policyholders can't match.

VALUING AN OFFER

How would you go about determining the value of a life-settlement offer? The financial analysis is complex, but we'll present an example here based on the following facts:

- The policy that is to be sold is a $5,000,000 level death benefit universal life policy with a required premium of $175,000 through the 10th policy year, after which premiums are flexible.
- The policy was issued "standard non-smoker" in October 1998 to a 72-year-old male.
- As of October 2001, the policyholder was determined to have a remaining life expectancy of five years.
- The policy's cost basis was $525,000 with no surrender value due to surrender charges.
- The life-settlement firm paid $1,448,500 for this policy in October 2001. The seller netted out either $1,079,100 or $1,263,900, depending on whether ordinary income or capital gains apply. For this example, we'll assume that capital gains is the correct way to pay taxes and the net proceeds are $1,263,900 to the policy seller—although a conservative interpretation would be about $200,000 less.

Using these assumptions, here are the steps you would use to analyze a life-settlement:

TABLE 1. VALUING A LIFE-SETTLEMENT OFFER: AN EXAMPLE

Assumptions: Policy is a $5 million level death benefit universal life; required premium of $175,000 through 10th year, flexible premiums from then on. Policy was issued in October 1998 to a 72-year-old male, non-smoker, standard. Net proceeds are assumed to be $1,263,900. Policy sold in October 2001, at which time holder's life expectancy was five years.

Insured	Present Value of		Retained	Net Sales	Advantage If
Dies*	Death Benefits	Premiums	DBs – Prems	Proceeds	Retained
2002	$4,761,905	$166,667	$4,595,238	$1,263,900	$3,331,338
2003	4,535,147	341,667	4,193,480	1,263,900	2,929,580
2004	4,319,188	500,397	3,818,791	1,263,900	2,554,891
2005	4,113,512	651,568	3,461,944	1,263,900	2,198,044
2006**	3,917,631	795,541	3,122,090	1,263,900	1,858,190
2007	3,731,077	932,658	2,798,419	1,263,900	1,543,519
2008	3,553,407	1,107,486***	2,445,921	1,263,900	1,182,021
2009	3,384,197	1,312,568	2,071,629	1,263,900	807,729
2010	3,223,045	1,554,296	1,668,749	1,263,900	404,849
2011	3,069,566	1,815,209	1,254,357	1,263,900	–9,543

* *Assumes insured dies in October.*
** *Life expectancy.*
*** *Expected premium through 2007 is $175,000, then increasing in each subsequent year to $246,000, $303,000, $375,000 and $425,000 respectively.*

- Calculate the aftertax value of the sales proceeds using both the ordinary income ($1,079,100) and the capital gain ($1,263,900) alternatives.
- For a period extending to twice the insured's life expectancy (to be conservative), calculate the death benefit's present value each year using a reasonable discount factor. (Since the measuring point is the October 2001 life-settlement purchase offer, future death benefits need to be discounted back to that date.) For example, a $5,000,000 death benefit that is paid out in five years, discounted at 5%, has a present value (October 2001) of $3,917,631.
- For a period extending to twice the insured's life expectancy, calculate the expected premium payments' present value for each year. The expected premium for the first five years after the sale of the policy is $175,000; the present value, discounted at 5%, is $795,541. This represents the cost to the policyowner if the policy is retained.
- Subtract the present value of the expected premiums from the present value of the death benefits, and compare that figure to the net sale proceeds. Using our example for the fifth year (2006): $3,917,631 – $795,541 = $3,122,090; this figure is then compared with the net sales proceeds, which in the example is either $1,079,100 or $1,263,900. In other words, the net present value if the policy had been retained and the insured dies in five years is $3,122,090, compared with net proceeds of either $1,079,100 or $1,263,900—a clear advantage for retaining a policy.

Table 1 shows this analysis for other years of life expectancy. In certain circumstances, you would also make special adjustments that are relevant to a particular case. For example, if the life-settlement firm has taken a large policy loan as part of the purchase proceeds with the attendant loan interest costs, then if the policy were retained by the policyowner they wouldn't take the loan and this needs to be accounted for in the analysis.

I reviewed two other life-settlement policy purchases and the financial analysis came out very close to this one. This study confirms the investment return of 12% to 15% that the life-settlement firms claim they try to achieve. Based on this case study, the pretax return should be around 18% and the aftertax return about 12%—measured at a life expectancy of five years. Because life expectancy refers to approximately half dying before and half after the specified time, in the aggregate life-settlements firm should achieve the investment return they plan for. But each individual insured will have different financial results depending on which side of the average they fall, which is why it is important to evaluate the financial prospects so each potential policy seller can assess the advantages and disadvantages according to their own view. In general, you can expect the crossover point to be about twice life expectancy. Based on this case study (and probably generally true) there is about a 10% probability that the insured will be alive when retention of their policy becomes less valuable than having sold it. Put another way, there is a 90% probability that having retained the policy is more beneficial.

CONCLUSIONS

If you are considering the sale of a life insurance policy, make sure at the very least that you consider the following:

- Have an independent financial analysis done before selling a policy. The life-settlement firm isn't in the business to determine what is in the best interests of prospective sellers.
- If selling appears to be in your best interests, obtain several purchase offers. Don't rely on only one life-settlement firm offer.✦