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# Spotlight on life settlement transactions: Getting the best value

By: Jason T. Mendelsohn

The law known as the Tax Cuts and Jobs Act (the TCJA)[1] contained two provisions that affect life settlements. First, the TCJA increased the estate tax exemption (it is $11.4 million per individual and $22.8 million for married couples for 2019).[2] This provision will sunset in 2026. Wealthy families who are affected by the increase's pending expiration have concerns about what they should do with life insurance put in place for estate protection. Another provision changed how life settlements are taxed, making life settlements more favorable for sellers and making the tax due on the proceeds from a life settlement easier to calculate for CPAs.[3]

Both of these new provisions did not go unnoticed by life settlement providers/investors, igniting a renewed level of direct marketing to consumers. Direct marketing exploits a crack in the chain of fiduciary oversight and places senior clients in a position where they might enter into a contract to sell their life insurance policy without having anyone to protect their best interests in the life settlement transaction.

This article discusses factors that have affected life insurance owned by senior clients and why so many seniors are selling their life insurance policies when they are not represented by a fiduciary at a time when they may need one the most. The article ends with a list of best practices to alleviate the confusion that has caused many fiduciaries to avoid discussing life settlements with their clients, leaving them vulnerable to direct-to-consumer marketing on the subject.

## Tax practitioners who are wary about discussing life settlements are not alone

In 2018, Ashar Group conducted a survey of 454 CPAs. Of those survey respondents, 48% held job titles of owner, partner, principal, president, CEO, or shareholder. The first question on the survey was designed to find out why more CPAs do not discuss life settlements with their clients. Respondents were asked to complete the sentence: "I don't feel comfortable talking with my clients about life settlements because …"

- 59% said: "I don't feel qualified to discuss life settlements."
- 28% said: "It's not part of my job responsibilities."
- 13% said: "I've heard stories that make me feel uncomfortable about life settlements."

Why do the majority of CPAs feel unqualified to discuss life settlements? There are no special qualifications to discuss life settlements, as long as the CPA does not receive any money from the policy's sale proceeds or from any outside sources. The CPA does not need to be licensed to sell life insurance or be registered as a life settlement broker to discuss life settlements with clients. Rules covering life settlements substantiate what practitioners already know to be true for attorneys, CPAs, or financial advisers who act in a fiduciary capacity to protect their client's best interest and take a fee for services.

A model act adopted by the National Conference of Insurance Legislators (NCOIL) clearly states that CPAs, attorneys, and financial planners that commonly represent clients in a purely advisory capacity are not considered to be life settlement brokers and therefore cannot be compensated by a life settlement provider or any other person, except their client (the policy owner).[4] Even though CPAs can provide advice about life settlements that is in their clients' best interest, they do not have a fiduciary duty in the life settlement process under the NCOIL model act.

## Who has a fiduciary duty to the client in the life settlement process?

Choosing the best life settlement resource to work with to represent a client who may benefit from a life settlement can be confusing. It is easy to be misled about who represents whom and how value is created for the client. In the life settlement industry, there is a buy-side and a sell-side similar to other investments. It is important to understand who sits on the same side of the table with the CPA and the client in the life settlement process.

On the buy-side, a life settlement provider/buyer is the representative for the institutional investors. The life settlement market is regulated in the majority of states and requires special licensing. For this reason, most institutional investors choose to use a life settlement provider who is licensed to handle the life settlement process so that investors do not have to go through the cumbersome task of securing and renewing licenses in multiple states. The provider/buyer is obligated to the individual or entity purchasing the life insurance policy on the secondary market and works to secure the highest internal rate of return for the investor(s).

The provider cannot serve two masters; therefore, a provider/buyer does not have a fiduciary duty to the client

1. P.L. 115-97.
2. Sec. 2010(c)(2)(3) as amended by TCJA §11061(a); 2019 inflation-adjusted amounts are in Rev. Proc. 2018-57.
3. Sec. 101(a). Life settlements are commercial transactions where life insurance policy holders (usually individuals) sell their life insurance policy to a third party.
4. National Council of Insurance Legislators (NCOIL) Life Settlements Model Act, §2(B).

### Fiduciary duties in the life settlement process

| Fiduciary role advising clients | Life settlement fiduciary duty to policy owner/seller | Duty to protect investment returns |
|---|---|---|
| Attorney<br>CPA<br>Certified Financial Planner<br>Chartered Life Underwriter<br>Family office<br>TOLI trustee<br>Registered investment adviser<br>Others | Licensed life settlement broker/fiduciary | **Provider/buyer**<br>Institutional investors<br>Private-equity firms<br>Global banks<br>Reinsurers<br>Asset managers<br>Pension funds<br>Municipal funds<br>Portfolio aggregators |

Source: Ashar Group LLC (2019).

even if a CPA is involved as a fiduciary adviser for the client. The provider/buyer can represent one fund, a group of funds, or the provider's personally owned fund(s). In other scenarios, the provider/buyer is not the owner of any of the funds that it represents, and some providers aggregate policies for a portfolio they then sell in the tertiary market.

The chart "Fiduciary Duties in the Life Settlement Process" shows who owes a fiduciary duty to whom in the life settlement process.

On the sell-side, a life settlement broker has a legal fiduciary duty to the policy owner/seller during the life settlement process. A broker, as the seller's representative, facilitates the negotiations that protect the seller's interests in a life settlement auction. NCOIL's model act defines the role of a broker as an individual or entity that represents the policy seller (Owner), owes a fiduciary duty to the Owner, and must act in the best interest of the Owner.[5] The broker sits on the same side of the table with the seller and the seller's advisers and is the only legally appointed representative who carries the fiduciary torch for a client in the life settlement process itself.

A competent broker has the policy owner/seller and the adviser sign an engagement agreement and then skillfully designs a case that will be presented to the secondary market to maximize value to the seller. The broker follows all compliance and Health Insurance Portability and Accountability Act (HIPAA)[6] procedures, protects sensitive client data, and manages the expectations of the policy owner and his or her adviser/advisory team. The broker, as the

5. Id.

6. Health Insurance Portability and Accountability Act (HIPAA), P.L. 104-191.

## EXECUTIVE SUMMARY

- The law known as the Tax Cuts and Jobs Act (TCJA) affected life settlement transactions in two ways — by doubling the estate tax exemption, which made it less necessary for many wealthy families to keep life insurance policies, and by making the taxation of the sale of life insurance policies, i.e., life settlements, more favorable to sellers.
- Life settlement brokers have a fiduciary duty to the policy owner in a life settlement transaction. Policy owners who use brokers rather than dealing with buyers themselves usually obtain a higher price for their policy.
- The TCJA equalized the tax treatment of the surrender of a life insurance policy and a life settlement.
- Before attempting to negotiate a life settlement, a policy owner should always obtain an appraisal of the value of the policy from a qualified appraiser.
- The recent sustained period of low interest rates has caused many current assumption universal life policies to become too expensive for policy owners to keep. A life settlement will often be a better option for these policy owners than allowing the policy to lapse or surrendering the policy.
- CPAs can provide a valuable service by inquiring about a client's life insurance policies and providing the client advice or referring the client to a competent life settlement broker if the client has policies that may be in danger of lapsing or that the client is considering surrendering.

life settlement fiduciary in the transaction, handles the negotiation process and creates a competitive bidding auction between life settlement buyers.

For a highly desirable policy, it is not uncommon to go through 10 to 15 rounds of bidding to generate 20 to 30 bids and incremental bid increases. The providers/buyers usually pay a substantially higher price to acquire the policy when a broker is involved than they would if the policy owner/seller works directly with a provider. The chart "Bid Transparency: Competitive Auction Process," on p. 456, shows an abbreviated bid matrix that demonstrates why CPAs need a life settlement broker to create competition and to ensure their clients have a licensed fiduciary to protect their best interests in the life settlement process.

## Due diligence that protects CPAs and their clients

One of the most confusing aspects of the life settlement market is related to determining who represents whom. The art of omission is a common tactic used by providers/buyers/direct marketers that can easily mislead consumers and advisers. CPAs hear a lot about "fair value," which in reality is discounted fair market value (FMV) that is higher than cash surrender value (CSV). CPAs should demand FMV for their clients and verify the auction process used to achieve it. Here are several due-diligence questions CPAs should ask any life settlement provider/buyer or life settlement broker to choose the right one:

- Do you have a licensed fiduciary duty to represent the best interests of my client in the life settlement process?
- How many years have you been involved in the life settlement industry?

**Clients likely receive several direct life settlement solicitations every day from television, radio, social media, publications, and the internet.**

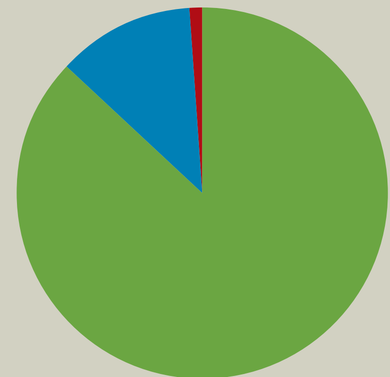
- Can you provide information to validate your good reputation in the industry?
- Do you provide bid transparency?
- How do you handle privacy and protect sensitive client data and medical information?
- Have any of the principals or members of your team been involved in litigation relating to life settlements?

## It is now safe to go back into the water

The first survey question showed that 13% of the CPAs said, "I've heard stories that make me feel uncomfortable about life settlements." That is understandable when one considers the early history of the life settlement market, which was controversial at best. Viatical settlements, which are different from life settlements, originally involved sales of life insurance policies by people who were suffering from HIV/AIDS in the 1980s, providing much-needed cash for terminally ill patients.

Viatical settlements were followed by the stranger-originated life insurance (STOLI) debacle, which also left a bad taste in the mouths of the fiduciary community. In a STOLI arrangement, a person purchased life insurance for an unrelated third party solely as an investment, rather than to benefit beneficiaries, and circumvented the life insurance requirement that the owner of the policy have an insurable interest in the person whom the insurance covers. Both NCOIL and the National Association of Insurance Commissioners (NAIC) have introduced model acts to help stop the trafficking of life insurance policies by STOLI programs.[7] Laws that prohibit STOLI have been enacted in 20 states.[8] Prudent investors want to avoid investing in risky STOLI policies, and life settlement providers/buyers that purchase life insurance policies for investors will not touch any policy that has even a hint of STOLI. Life settlement brokers

**Representative sample of settled policies, by type**



- Universal life (including current assumption, survivorship, indexed, guaranteed, and variable UL products) ....87%
- Term insurance ..............12%
- Whole life..........................1%

Source: Ashar Group LLC (2019).

7. Kingma and Leimberg, "Deterring STOLI: Two New Model Life Settlements Acts," 35-7 *Estate Planning* 3 (July 2008).
8. Casey and Coan, "The Rise of Stranger-Originated Life Insurance Lawsuits," 2011 *Emerging Issues* 6111 (Dec. 2, 2011), available at tinyurl.com/y5n2ymk8.

### Bid transparency: Competitive auction process

| Offer matrix | | Face value = $4,000,000 | | Cash surrender value = $109,088 | |
|---|---|---|---|---|---|
| | | Round 1 | Round 2 | Round 3 | Final |
| Buyer 1 | Offer | $411,000 | | | $411,000 |
| Buyer 2 | Offer | $800,000 | $1,100,000 | $1,320,000 | $1,320,000 |
| Buyer 3 | Decline | | | | |
| Buyer 4 | Offer | $925,000 | $1,250,000 | $1,450,000 | $1,475,000 |
| Buyer 5 | Offer | $850,000 | $950,000 | $1,300,000 | $1,225,000 |
| **Buyer 6** | **Accepted** | **$975,000** | **$1,215,000** | **$1,400,000** | **$1,550,000** |
| Buyer 7 | Offer | $1,040,000 | $1,085,000 | | $1,085,000 |
| Buyer 8 | Offer | $725,000 | $995,000 | | $995,000 |
| Buyer 9 | Offer | $875,000 | $1,090,000 | | $1,090,000 |
| Buyer 10 | Decline | | | | |
| Buyer 11 | Decline | | | | |
| Buyer 12 | Offer | $480,000 | | | $480,000 |

Source: Ashar Group LLC (2018).

have anti-fraud methods to detect these types of schemes or bad behaviors.

Early life settlement regulations focused on preventing fraud and protecting insurance carriers. However, over the past several years, there has been a shift in life settlement rules to protect consumers' right to sell their life insurance policies. NCOIL introduced the Life Insurance Consumer Disclosure Model Act, which has a provision that requires carriers to disclose the settlement option to individuals who are age 60 or older or who are known by the insurer to be terminally or chronically ill and who are considering surrendering a policy.[9] A version of this is currently statutory or regulatory law in several states:

- Kentucky, Ky. Rev. Stat. §304.15-075(3)(b);
- Maine, Me. Rev. Stat. tit. 24-A, §6808-A(4)(D);
- New Hampshire, N.H. Code Admin. Rules Ins. 302.07;
- Oregon, Or. Rev. Stat. §744.362;
- Washington, Wash. Rev. Code §48.102.100(1); and
- Wisconsin, Wis. Admin. Code Ins. §2.18(8).

Currently, 44 states regulate life settlement transactions through their insurance codes.[10]

## The TCJA improves the tax treatment of a life settlement

A further example of how the scales are tipping in favor of consumer rights is the way the TCJA addressed the highly contested issue of how life settlements are taxed. Section 13521(a) of the TCJA overrules the IRS's previous position on this matter. The first IRS ruling on life settlement tax treatment, Rev. Rul. 2009-13, was issued on May 1, 2009, as it became clear that life settlements were gaining in popularity and here to stay. The much-anticipated revenue ruling addressed the tax consequences of life settlements to sellers. This revenue ruling created more awareness of the option of life settlement for policy owners and signaled a coming age of life settlements to the planning community.

However, instead of bringing clarity to financial professionals, advisers, and their clients on the tax treatment of the sale of clients' life insurance policies, it raised more questions than answers about this emerging market. The problem with Rev. Rul. 2009-13 was that the tax treatment of a policy sale was treated differently than the tax treatment of a policy surrender. This difference in taxation hampered insurance policy sales on the secondary market, negatively affected consumer confidence, and made it more difficult for practitioners to calculate taxes for life settlements. The ruling imposed a formula on life settlements requiring a calculation that deducted the cost of insurance (COI) from the policy's cost basis.

9. NCOIL Life Insurance Consumer Disclosure Model Act §§3 and 4.

10. Casey and Sherman, "Looking Back at the Life Settlement Industry in 2018," Law360.com (Jan. 29, 2018), available at tinyurl.com/y3nscjsx.

COI is a calculation that one might think could easily be provided by the insurance carrier. Unfortunately, it became abundantly clear that COI was often very difficult, if not impossible, to obtain from the carrier. Advisers consequently hit roadblocks in their planning, and often had to gather dozens of policy statements from previous years to piece together their analysis. On the other hand, when a policy owner surrendered a life insurance contract, no such penalties were imposed on the client. This seemed inherently unfair to policy owners seeking to benefit from a life settlement.

The TCJA corrected this inconsistency and eliminated the requirement for practitioners to remove COI from the cost basis of a policy sale, thereby putting life settlements on a level playing field with other policy exit strategies. Those tax changes have significant implications for clients choosing to sell their life insurance policy on the secondary market and result in substantial tax savings for sellers. For universal life (UL) and term insurance policies, COI represents most, if not all, of the premiums paid. Now, under the TCJA, the premiums paid — which include COI — equal the cost basis, thereby lowering the total tax obligation resulting from a life settlement. Another benefit is a more simplified tax calculation for tax professionals without the unnecessary obstacle of trying to determine the COI. Example 1 demonstrates the effect of these changes:

***Example 1. TCJA's changes in taxation to the seller of life settlements:***

***Policy type:*** $1 million UL insurance policy.

***Factors:***

- Life settlement proceeds to seller = $90,000.
- Premiums paid = $64,000.
- COI = $20,000.
- CSV = $30,000.

**An Insurance Studies Institute poll revealed that 50% of seniors are unaware of life settlements. This should be a red flag to fiduciaries who have senior clients.**

***Calculations under Rev. Rul. 2009-13:***

*Step 1:* Computation of basis: $64,000 premiums paid – $20,000 COI = $44,000 adjusted basis

*Step 2:* Computation of tax liability: $90,000 sale price – $44,000 adjusted basis = $46,000 taxable gain

***New methods of calculation resulting from the TCJA:***

*Step 1:* Computation of basis: $64,000 premiums paid = $0 taxation for up to $64,000 of the sale price

*Step 2:* Computation of tax liability: $90,000 sale price – $64,000 basis = $26,000 taxable gain as a long-term capital gain

The TCJA's change reduces the taxable gain in Example 1 from $46,000 to a more favorable $26,000. The new calculation is more in line with how policy gains are taxed when policies are surrendered back to the insurance carrier that issued the policy. Ultimately, the revision to the law brings more clarity to planning professionals and the clients they serve.

With an aging population facing the reality of outliving their savings, a significant number of individuals are searching for ways to fund their independence and long-term-care needs. Life settlements might be the option that helps people uncover the liquidity needed to solve other planning needs. An ancillary benefit would also contribute to the mental and financial freedom of the older generation's adult children, who will not need to reallocate their planning dollars to fund their parent's needs. Instead, 40- to 60-year-olds will be able to focus on their own planning needs so that they can avoid the complicated consequences of outliving their own financial plans.

## Informed people make better decisions

The second question the Ashar Group asked in its survey dealt with life insurance valuation. The survey asked respondents, "When was the last time you suggested to your clients that they should get their life insurance appraised?"

- 82% said: "Never."
- 13% said: "Within the last six months."
- 5% said: "Within the last six weeks."

These answers indicate that the vast majority of CPAs never suggest getting an appraisal of the present value of a life insurance policy for any clients. The same is true for most fiduciaries, who do not feel qualified or obligated to discuss life settlements with their clients. This means that there is often no one acting in a fiduciary adviser capacity on behalf of the client requesting an appraisal before the client decides to lapse or surrender a policy that he or she no longer wants or needs. This creates a void that is being filled by life settlement providers/buyers marketing direct to consumers, none of whom owe a fiduciary duty to the CPA's client.

The introduction to this article noted the significant increase in life settlement direct marketing to consumers and warned that "direct marketing exploits a crack in the chain of fiduciary oversight and places senior clients in a position where they might enter into a contract to sell their life insurance policy

without having any advocate at the table to protect their best interests in the life settlement transaction." This "crack in the chain of fiduciary oversight" is more like a massive sinkhole that far too many seniors are falling into.

CPAs and other fiduciaries who see their clients regularly most likely assume that their client's insurance adviser or some other adviser is watching over policy performance and ordering appraisals when needed. This author's experience would indicate that this is simply not true. Many of the seniors selling their policies purchased them many years ago. In some cases, the insurance broker who wrote the policy is now either retired or deceased. The same is likely true for the clients' CPA and attorney who were involved when the policy was originally issued. Usually, no insurance representative is following up on how the policy is performing. The planning community refers to these as "orphaned policies" because there is no insurance specialist or anybody in a fiduciary relationship with the policy owner monitoring these policies. Fiduciaries who could help senior clients are often unaware of this lack of representation and therefore do not get involved.

Providers/buyers and their direct marketing surrogates are very aware of this "crack in the chain of fiduciary oversight" and are taking it upon themselves to educate policy owners about life settlements. In the absence of fiduciary representation, providers/buyers hope to engage policy owners before they lapse or surrender their policies so that they can purchase these policies at a discount for institutional investors. An Insurance Studies Institute poll revealed that 50% of seniors are unaware of life settlements.[11] This should be a red flag to fiduciaries who have senior clients.

Seniors would be best served by first getting information about life settlements from their advisory team. Providers/buyers have no obligation to determine what is best for the policy owner. The issue of suitability is not something that providers/buyers address since they are licensed only on the buy-side. Advisers with a fiduciary responsibility to protect their client's best interests are in the best position to explore hold, change, surrender, or sell decisions to determine if a life settlement makes sense in the first place. If the decision is made to sell the policy, the adviser should contact a full-service licensed life settlement broker to design the case and handle negotiations and the closing process. Without proper representation, no competitive auction will occur, and settlement payments made to unrepresented policy owners are often substantially lower than offers resulting from the auction process controlled by a competent life settlement broker/fiduciary.

## Willing buyers change the face of life insurance valuation

Life insurance is often one of a client's most valuable assets and can be appraised just like any other valuable asset. Fiduciaries who advise their clients on financial matters such as the sale of a business, real estate holdings, fine art, or other valuable assets usually start by requesting an appraisal from a qualified appraiser. The same process can be followed when working with clients who need to make hold, change, surrender, or sell decisions concerning their life insurance. If a client needs to determine the present value of his or her life insurance policy, the fiduciary should request an independent appraisal from a life settlement broker who is a qualified appraiser. Brokers who produce qualified life insurance appraisals avoid any conflicts of interest with the fiduciaries that use their services. Due diligence is necessary when choosing a resource for qualified appraisals.

Life insurance, especially UL insurance, has long been considered a hard-to-value asset. This is no longer true. The life settlement marketplace has matured to a point where comparable market data are readily available. Brokers who produce appraisals have defensible real-time market data available from multiple providers/buyers who have been forced to compete. These data have enabled the development of a life insurance valuation methodology that accurately reflects the market. A market-based secondary market valuation (SMV) determines the FMV of an in-force life insurance policy if it were to be sold on the secondary market. The SMV is a mark-to-market life insurance valuation that incorporates individualized longevity analytics and conforms to the IRS's willing buyer/willing seller definition of FMV.

Determining FMV for whole life and renewable term products is pretty straightforward. When universal life entered the picture, the calculation of interpolated terminal reserve (ITR) provided on Form 712, *Life Insurance Statement*, became much more complicated. Each insurance carrier uses its own formula to determine ITR, which leads to inconsistent results. If a client purchased two identical UL products, on the same date, from two carriers with the same face value and premium payments, it is highly probable that years later, the Form 712/ITR calculations would vary greatly from one carrier to another.[12]

Here is the problem: If these values vary so much, then which one is accurate? In the IRS's eyes, they both are. The ITR value or PERC (premiums plus earnings less reasonable charges) value is considered a safe harbor. However, when it comes to valuing UL and

11. Siegert, "Portrayal of Life Settlements in Consumer Focused Publications," SSRN.com (Sept. 10, 2009), available at ssrn.com/abstract=1558742.

12. Buck and Leimberg, "Life Insurance Valuation: What Advisors Need to Know," *LISI Estate Planning Newsletter* No. 1638 (May 10, 2010).

annual renewable term products, many practitioners use an alternative valuation such as SMV value.

The following examples address clients of different ages, health, and life circumstances and whether they should keep their current life insurance policy or do a life settlement.

Example 2 compares two value calculations.

***Example 2. Form 712/ITR value vs. SMV value:***

**Planning objective:** Determine the SMV value of a $10.8 million guaranteed no-lapse UL (GUL) policy selling from an individual estate to a trust.

**Case background:**

- Female age 64, with substandard health.
- Life expectancy 11-13 years.
- Policy basis = $2.73 million.
- CSV = $0.

The attorney involved contacted the insurance carrier informally by phone asking them to indicate what the ITR value would be if she ordered a formal 712/ITR:

- The potential Form 712/ITR value was more than twice the policy basis. This figure seemed unreasonably high, so the attorney ordered a formal report of SMV value from a life settlement broker who is also a qualified life insurance appraiser. The market-based SMV value = $3.14 million.
- The SMV value was based on individualized longevity analytics for the insured and then presented to the market for providers to make competitive bids.

**Planning decision:** The attorney used the SMV as the foundation for choosing an alternative value to the Form 712 value.

**Note:** It is up to the attorney to determine what value to use. Independent life settlement brokers do not give legal advice or financial planning advice.

**Universal life insurance attracts investors because it has a flexible premium structure, which can be manipulated by investors to maximize profit.**

**Practice tip:** Planners should never order a formal Form 712 without first requesting an estimated value and understanding the implications. Once the Form 712 is produced, its value cannot be changed.

***Example 3. Fiduciary issue – trust-to-trust sale:***

**Planning concerns:** There was concern over potential litigation from family members when transferring from trust to trust and changing beneficiaries. The original trust would receive cash from the purchase of the life insurance policy. The policy would be placed in the new trust for the new beneficiaries. The first trustee wanted the highest value; the second trustee wanted the lowest value.

**Planning objective:** Determine the SMV value for a defensible transfer.

**Case background:**

- Male, 82, with only age-related health conditions.
- $7 million GUL.
- CSV = $2,260,129
  The attorney ordered a formal SMV Report to help substantiate FMV.
- SMV value = $2.7 M.

**Planning decision:** The original trust received a gift of $2.7M and the new trust received the $7M policy for the new trust beneficiaries.

***Example 4. Retiring business owner extracts business term policy from the sale of the business:***

**Planning objective:** The retiring business owner's business adviser suggested that her client determine if the business-owned term policy had any SMV value. The prospective buyer of the business had no interest in keeping the term policy on the seller and making ongoing premium payments. (Note: Since life insurance is not noted on the business balance sheet, business valuation reports do not recognize it. Knowledge of this fact can be an opportunity for the sell-side or the buy-side depending on whom the attorney/adviser represents.)

**Case background:**

- Male, 73, selling his business.
- $8 million business-owned convertible term insurance policy.

Insured in good health with only age-related health issues. CSV = 0. The business owner's attorney ordered a report of SMV value. SMV = $780,000. The business adviser was aware of potential SMV value and negotiated the transfer of ownership of the business-owned policy to the retiring business owner without affecting the amount of proceeds obtained from the sale of the business. The attorney representing the prospective buyer was unaware of the potential for a term policy to contain SMV value. The buyer was agreeable to the transfer.

### Percentage of settled policies, by product type

| Product | Number of responses | Median percentage | Median average face amount |
|---|---|---|---|
| Whole life | 3 | 19% | $53,000 |
| Traditional UL | 5 | 45% | $724,000 |
| Variable UL | 2 | 4% | $870,000 |
| UL with secondary guarantees | 4 | 49% | $1,085,000 |
| Joint and last survivor | 2 | 12% | $2,287,000 |
| Term | 4 | 26% | $230,000 |
| Other* | 2 | 100% | $950,000 |
| **Total number of respondents** | **8** | | |

* Two respondents were unable to determine the policy type and responded "other."

Source: Report of Society of Actuaries (SOA) Life Settlements Survey Subcommittee (2010).

Be sure to request an appraisal of SMV value from a qualified appraiser of life insurance that uses real-time secondary market data to determine value when helping senior clients make hold, change, surrender, or sell decisions about their UL or convertible term life insurance.

## Senior policy owners surrender policies and leave money on the table

Senior clients often forfeit their unwanted or unneeded life insurance policy back to the insurance carrier without first getting a qualified appraisal of SMV value. A GAO study found that seniors selling their policies in a life settlement transaction received almost eight times as much money as they would have had they surrendered the policy to the insurance company.[14]

It is important to get a feel for what providers/buyers look for when seeking to purchase an in-force policy. There seems to be much confusion among advisers and fiduciaries about the type of policy that providers/buyers want to purchase. The Ashar Group survey asked respondents to answer true or false to the following statement: "Buyers want to purchase policies with high cash values."

- 67% said: "True."
- 33% said: "False."

The correct answer is false. An overwhelming majority of polices that have been purchased by investors over the past two decades have been either UL or term insurance — both of which often have little or no CSV. The chart "Percentage of Settled Policies, by Product Type" shows the percentage of policies settled, by policy type.[15]

The chart originally appeared in a Society of Actuaries survey of insurance carriers about life settlements and gives an indication of policy types most commonly settled. Traditional current assumption UL (CAUL) and UL with secondary guarantees (SGUL) were the product types that were most commonly sold on the secondary market. Investors have plenty of cash, and they are looking for policies low in cash and high in health arbitrage.

## Universal life insurance and life settlements

When UL insurance was first introduced, it was in the form of CAUL. That means that the crediting rate is determined by current interest rates and can fluctuate over time. In a high-interest-rate environment, these policies accumulate significant cash value. If interest rates are low, then the inside cash buildup is depleted. At that point, policy premium payments need to be increased in order to keep the policies in-force.

UL insurance attracts investors because it has a flexible premium structure, which can be manipulated by investors to maximize profit. This premium flexibility is one of the features that also attracted consumers and estate planners toward UL. CAUL differs from other types of nonguaranteed permanent life insurance. The growth of the policy's cash value is based on a flat crediting rate that is established by the insurance carrier.[16] By contract, the insurance carrier can adjust the crediting rate, and

14. U.S. Government Accountability Office, "Life Insurance Settlements: Regulatory Inconsistencies May Pose a Number of Challenges," Report to the Special Committee on Aging, U.S. Senate (July 28, 2010), available at tinyurl.com/y3zhx3mz.
15. Society of Actuaries, *Report of the Society of Actuaries Life Settlements Survey Subcommittee* (January 2010), available at tinyurl.com/yyozj8cv.
16. Board of Governors, Federal Home Loan Mortgage Corp., Moody's, retrieved from the Federal Reserve Economic Database (maintained by the Research division of the Federal Reserve Bank of St. Louis).

insurance carriers do not make crediting rate history public. Life insurance crediting rates were heavily affected by interest rates that were in the double digits in the 1980s. By 2008, interest rates fell below 4% and are still at that level today.

The 10-year Treasury note's yield is one of the most widely tracked rates and is used as a benchmark for other types of debt such as Fannie Mae and Freddie Mac, and is the barometer for 30-year fixed mortgage rates, auto loans, and credit card annual percentage rates.[17] This has created a serious problem for insurance carriers that had guaranteed a crediting rate of 4% to policy owners on CAUL products. Once crediting rates dipped below 4%, carriers had to increase the COI rates charged to policy owners in order to remain profitable. For orphaned policies, this increase largely goes unnoticed and eventually puts policies in danger of lapsing for lack of funds.

Advisers and consumers who were familiar with whole life polices — the default product for estate planning for the previous two centuries — were caught off-guard by the new management responsibilities that accompanied CAUL. Traditional whole life insurance products have fixed premiums, and there is no need for the policy owner or advisers to manage the performance of the policy. CAUL offered consumers greater flexibility to deal with rapidly changing investment needs, while maintaining the tax advantages of traditional whole life insurance. The premium flexibility of CAUL, which was so attractive to advisers and consumers, essentially shifted some of the performance risk from the insurance carrier to the policy owner.

Early on, consumers were often enticed by projections of interest rates in the high single to low double digits. While interest rates are only projections, most insureds assumed that their policy would perform as projected, due to their previous experience with whole life insurance. Additionally, advisers and fiduciaries who were not insurance professionals were often unaware of the significant changes in UL policy design and the need to monitor. By the early 1990s, it was clear that UL insurance policies had the potential to fail if neglected.

> **The CPA does not need to be licensed to sell life insurance or be registered as a life settlement broker to discuss life settlements with clients.**

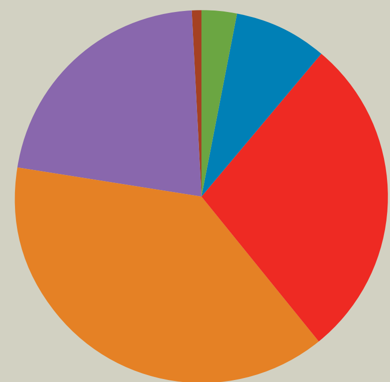
Ashar Group internal data verify the fact that UL and term insurance account for the majority of policies that are settled on the life settlement market (see the graphic "Representative Sample of Settled Policies, by Type," p. 455). All types of UL insurance are purchased by providers/buyers, but CAUL accounts for the majority of UL policies settled. Ashar Group expects to see an increase in forms of GUL insurance on the secondary market as the Baby Boomers with rapidly changing needs and priorities move through the system over the next 20-plus years.

Ashar Group's records also indicate that policies with death benefits of $1 million or more are usually owned by a trust or a corporation. Policies with a death benefit of $500,000 or less are usually owned by individuals. Trust-owned or corporate-owned policies are much more likely to have fiduciary adviser oversight. However, in both instances many of these policies are not properly managed and end up on the life settlement market. If policy premiums were not periodically increased to keep up with the rising COI and losses due to a sustained low-interest-rate environment, these policies fail.

## Broken policies flood the market

Several articles have appeared recently, warning of steep increases in UL insurance premiums that clients are being charged to keep their life insurance in force. One such article in *The Wall Street Journal*, discusses the effect of COI increases that have led seniors to lapse their policies destroying what was once

### Representative sample of settled policies, by age of insured*



- 60 and under .................3.2%
- 61–70 ..........................8.16%
- 71–80 ........................28.00%
- 81–90 ........................38.53%
- 91–100 ......................21.63%
- 101 and older...............0.73%

* Percentages do not equal 100 due to rounding.

Source: Ashar Group LLC (2019).

17. Franck, "Here's the Number Everyone in the Financial Markets Is Obsessing About and Why," CNBC.com (Oct. 5, 2018), available at tinyurl.com/ya7zq74j.

a vital safety net.[18] Often, seniors who have paid premiums for decades have no option but to walk away from these policies because they cannot afford the premium increases.

CPAs and other fiduciaries who normally do not discuss life settlements with their clients may be the only advisers in position to step in and protect seniors. It is a good bet that some clients are forfeiting their failing or unneeded policies back to the insurance carrier without ever speaking to an adviser. Fiduciary advisers do not need a life insurance license or to be licensed as a life settlement broker to discuss life settlements with clients. Never allow your senior clients to lapse or surrender a UL or convertible term insurance product without first securing an appraisal of SMV value.

## How to discuss life settlements with clients

How do CPAs identify those clients who may benefit from a life settlement so that they can advise them about the financial benefit of a life settlement before they unknowingly surrender or sell their policy back to the insurance carrier for a predetermined contracted amount that is far below SMV value?

It may sound too simple, but by adding a single question to client checklists or asset valuation processes, a CPA can help prevent clients from lapsing or surrendering policies before exploring all policy exit strategies. This one question will allow CPAs to stop their clients from disposing of their policies before all options have been explored: "Should the client keep the policy and keep paying premiums, make changes such as reducing the death benefit, make a Sec. 1035 exchange of the insurance policy, surrender the policy, or sell the policy (hold, change, surrender, or sell)? The key is to catch clients before they allow the policy to lapse or surrender it. Ask them: "When was the last time you had your life insurance appraised?"

They might be surprised by the question, but it opens the door to a conversation about what plans they might have to lapse or surrender their life insurance policy at some point. If they are planning to surrender or allow their policy to lapse, the CPA should suggest a life insurance valuation to determine SMV value from a qualified appraiser as a part of the decision-making process. This valuation will determine the SMV value of the client's policy and could prevent the client from making a major financial mistake. SMV value is highly impacted by life expectancy. Currently, providers/buyers are most often seeking policies where the insured's life expectancy is 15 years or less. A sample of Ashar Group's internal data reveals the age ranges of settled policies (see the graphic "Representative Sample of Settled Policies, by Age of Insured," p. 461).

Remember, clients likely receive several direct life settlement solicitations every day from television, radio, social media, publications, and the internet. If they engage with these marketers directly, they will have no advocate to protect their best financial interests and could potentially become victims of senior financial abuse. Check with senior clients to ensure they are properly represented. Ask them, "When was the last time you had your life insurance appraised?" Include this question in a client checklist or the firm's asset valuation processes.

## The increased estate tax exemption creates new planning challenges

Much of the life insurance owned by wealthy families for estate protection is either traditional whole life with high cash values or GUL. Also, some affluent clients still own CAUL policies.

The ink was barely dry on the TCJA before life settlement providers/buyers increased the number of ads to life insurance policy owners to target senior clients who might no longer want or need their life insurance. Why are investors suddenly spending so much money to influence your clients? They hope to purchase policies from wealthy families who no longer need their life insurance purchased for estate protection.

It is not likely that a CPA's affluent clients affected by the increased exemption would engage with direct marketers without being represented by their planning team and a licensed life settlement broker. However, they may approach their CPA with questions about whether they should sell excess insurance that was previously needed for estate protection or if they should just sit tight until the 2026 sunset period passes. Investors purchased approximately $2.5 billion in life insurance face value in 2017, representing an increase in life settlement activity for the second consecutive year.[19] The life settlement industry is expecting an additional boost in policy flow because of the increased estate tax exemptions.

Below are some case examples resulting from questions that clients might ask because of the increased exemption:

***Example 5. Concern about the 2026 sunset clause:***

**Question:** "My mother is in her 90s. My siblings and I do not expect her to live past the 2026 sunset period. Is there any advantage to selling her policy now and applying the sale proceeds and premium obligations to other financial goals?"

**Planning concerns:** The mother, Edna, and her advisory team

18. Scism, "Universal Life Insurance, a 1980s Sensation, Has Backfired," *The Wall Street Journal* (Sept. 19, 2018), available at tinyurl.com/y3ppc8bt.

19. Conning Inc., *Life Settlements: Continued Growth, Positive Outlook* (2018).

are trying to make decisions about her life insurance that was previously needed for estate protection.

***Planning objectives:*** Determine what Edna's longevity horizon is. If it looks like she will live past the sunset period, what options should she consider? Should she keep paying premiums, or should she reallocate her premium payment plus the sale proceeds from a life settlement to other planning needs?

***SMV results:*** Edna's longevity analysis adds doubt to her assumption that she will not live past the sunset period. Edna is 91 years old with a family history of longevity, and the SMV predicted a life expectancy of four to six years. What that really means is that she has a 50/50 chance of living longer than six years.

***Planning discussion:*** The SMV indicates interest from providers. If she sold her $15 million policy, Edna could receive a $4.3 million lump sum from a life settlement. If she sells her policy, she will also be able to reallocate the $450,000 annual premium payments to other planning needs. This discussion can go any number of directions, but at least her planning team has data points from an SMV to help make an informed decision.

*Example 6. Female, age 89, is living longer than expected:*

***Question:*** "I have age-related health problems, but my doctor says I might live to be 100 or more. When my policy was issued 30 years ago, we were planning for a life expectancy of 85 years. Obviously, things have changed. Is there an accurate way to estimate my life expectancy to make sure we adjust my plan so that I don't outlive it?"

***Planning objective:*** Mary, who is the insured on five CAUL policies, is living longer than anyone expected. The policies are getting expensive to maintain, and her CPA wanted to know if the present value for each policy could be determined. The CPA wanted an explanation of the premium requirements in a variety of life-expectancy scenarios, so the planning team could determine if they should recommend a policy restructure or other available options. Their desired outcome was to provide more certainty in her financial and long-term-care needs.

The family was uncomfortable with the annual conversation of "to fund or not to fund" based on their loved one's projected life expectancy. Mary's CPA asked for a review of each policy separately and for the breakeven point (crossover point) where, if she continued to live, it would make more sense to sell one or more policies than to keep paying premiums.

The SMV reports showed the crossover points for each of the five policies. One of the policies had a crossover point at age 93, and Mary's individualized longevity analysis from the SMV report indicated that she could live into her late 90s or beyond. The CPA now had conclusive evidence to support recommending selling the policy with a crossover age of 93 at a later date and to use the proceeds from the life settlement to fund the remaining policies. If Mary is still living at age 92, her CPA plans to explore the option of a life settlement. It is a win-win for the family and offers documentation to substantiate the advisory team's recommendations.

*Example 7. 30% premium increase on female age 85:*

***Scenario:*** "The insurance carrier just informed me that my premiums are increasing significantly. Should I keep paying? How long should I expect to pay premiums? Does it make sense to keep the policy, or should I consider other options?"

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***Policy type:*** $8 million current assumption second-to-die UL (SUL).

***Factors:***

- The increase in premium payments has become a burden, and the client has been questioning the need to continue the policy.
- The policy was purchased in 1987 with both insureds in preferred health.
- The client's husband died in 2008.
- She has developed health issues beyond age-related health conditions.
- The policy had been trust-owned since 1987 and not properly managed.
- As a result, the CSV was only $322,000. Premiums were increasing by 30% from $170,000 annually to $221,000 annually partly because the policy has been underfunded due to lack of premium management

***Planning objective:*** Determine if it makes sense to keep paying premiums, make changes, surrender the policy for CSV, or do a life settlement.

### Reporting life insurance transactions

The TCJA added Sec. 6050Y to the Code. This new section requires the buyer of a life insurance contract to file an information return with the IRS reporting the sale and information about the sale, as well as requiring written statements to the life insurance company and the seller. The insurance company must also file an information return and furnish the seller with a written statement. The IRS issued proposed regulations on this new section in March (REG-103083-18).

**The key is to catch clients before they allow the policy to lapse or surrender it. Ask them: "When was the last time you had your life insurance appraised?"**

***Evaluation process:*** Her CPA ordered an SMV analysis to determine the client's individual longevity horizon based on life-expectancy projections using her family history, lifestyle, and current medical conditions. They needed to know if her policy had any SMV value beyond the CSV.

***SMV results:***

- The client's individualized longevity analysis was projected to be between three and five years.
- The SMV value was estimated to be $3.17 million if the policy was sold.

***Planning discussion:*** The SMV analysis provided the advisers with valuable data to help discuss options with the client and make an informed decision. The SMV proved that the policy's present value was worth significantly more than the CSV, and it would not be in the client's best interest to surrender the policy for $322,000.

Does it make sense to pay the increased premiums for a few years and then sell? Should the client sell it now and reinvest the sale proceeds and future premium obligations for other planning needs? Should she keep part of the proceeds and donate the rest to her favorite charity? Can she sell part of the policy and retain the rest for her beneficiaries?

***Bottom line:*** It is important to determine SMV value for your senior clients who own CAUL, SUL, GUL, indexed UL, SGUL, variable UL, or convertible term insurance policies in order to help them make informed hold, pay, surrender, or sell decisions.

## Life settlement best practices for fiduciaries

Fiduciaries should follow these best practices to ensure clients get the maximum value out of their policies:

- Engage the services of an independent life settlement broker if the client wants to sell his or her policy so that the client has a legal fiduciary protecting his or her best interests in the life settlement process.
- Request an appraisal of SMV value from a qualified appraiser when helping senior clients make hold, change, surrender, or sell decisions about their UL or convertible term life insurance.
- *Never* allow senior clients to lapse or surrender a UL or convertible term insurance product without first securing an appraisal of SMV value. Ask clients: "When was the last time you had your life insurance appraised?" Include this question in the client checklist or asset valuation process.
- Determine SMV value for your senior clients who own GUL polices and were impacted by the increased estate tax exemption in order to help them make informed hold, pay, surrender, or sell decisions. ■

### Contributor

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