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HOW TO SELL YOUR UNWANTED LIFE INSURANCE WITHOUT FALLING INTO TAX TRAPS

Life insurance can protect your dependents in case of your premature death and provide liquidity to your estate. At some point, though, you may have accumulated sufficient liquid assets so that an existing life insurance policy no longer is necessary.

Strategy: Sell your life insurance policy to a third party. Even after you pay tax on the proceeds, the amount you receive could well exceed the proceeds from cashing in the policy or allowing it to lapse.

AN EVOLVING MARKET

Such transactions used to be called “viatical settlements,” which involved policies sold by terminally ill individuals, often those with AIDS. However, recent medical advances have made it more difficult to forecast life expectancy for these patients, which makes it harder to set prices for such policies.

New look at old sellers: As a result, the focus today is on “senior life settlements,” in which policies are bought from individuals who are not terminally ill but who have relatively short life expectancies. With cancer, heart attacks, diabetes, etc., longevity may be predicted within a range of years.

How it works: Generally, a number of insurance policies are combined into a single security, which is sold to investors. Thus, your life insurance won't be held by a single investor who will be motivated to speed your demise.

Key: A policy that you bought when you were younger and healthier will have premiums that are low in relation to the

death benefit. If your health has worsened, buyers may be interested because those low premiums will make it cost effective for them to keep the policy in force.

As your health declines, the resale value of your life insurance rises.

Setting a price: The shorter the seller's life expectancy, the greater the purchase price as a percentage of the policy's face value.

Examples: Ann Thomas has a life expectancy between one and two years. A buyer might offer 60% of her policy's face value. That is, she might collect \$300,000 up-front for a \$500,000 life insurance policy because the investors hope to collect \$500,000 in a relatively short time.

On the other hand, Harry Johnson, with a 10-year life expectancy, might be offered only \$75,000 (15%) for his \$500,000 policy.

Policy matters: You may be able to sell either a term or a permanent (cash-value) life insurance policy...

- **Term insurance.** As you grow older, your term insurance rates, if not fixed by your policy's provisions, might become so high that you're reluctant to keep it in force. If your term policy can be converted to a permanent life insurance policy, a buyer may be interested.

- **Permanent life.** These policies (whole life, universal life, variable life) are favored by buyers.

TAX TREATMENT

Viatical payments made to terminally ill individuals escape federal income tax. Some states also honor this tax exclusion.

Required: A physician has to certify that death is reasonably expected within 24 months. The payment must come from a “viatical settlement provider” that will report the amounts received by the insured individual to the IRS on Form 1099-LTC, *Long-Term Care and Accelerated Death Benefits*.

Senior lifetime settlements, which don't involve a terminal illness, don't enjoy tax exemption. Instead, the tax consequences will depend on the amount paid and the seller's cost basis in the policy.

The seller's basis in the policy generally will be the amount of premiums paid less any cash dividends received.

Example: Tom Smith, age 68, has been covered by a \$2 million life insurance policy by his company. Smith, who has had a heart attack, is going to retire, so this coverage no longer is necessary.

Suppose a buyer, after looking at Smith's medical history and estimating his life expectancy, offers \$300,000 for the policy. Smith's company had paid \$300,000 in premiums and there have been no dividend payments, so the basis is \$300,000.

Outcome: With a \$300,000 basis and a \$300,000 purchase price, no taxes will be due. If Smith's company had paid only \$200,000 in premiums, taxes would be due on \$100,000 of income.

Tax rates: What tax rates would apply to that income? That depends on the nature of the policy...

- **Permanent life insurance.** The difference between the basis and the cash value will be ordinary income, taxed up to 35%. Any excess qualifies for the bargain 15% rate on capital gains.

Example: Assume a basis of \$200,000, cash value of \$220,000, and a purchase

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price of \$300,000. Of the \$100,000 gain, \$20,000 (\$220,000 cash value minus the \$200,000 basis) will be taxed as ordinary income while the remaining \$80,000 would be a long-term capital gain.

- **Term life insurance.** Such policies have no cash value, so it's uncertain whether ordinary income or capital gains rates apply. You might take an aggressive position and report all the taxable income as a long-term capital gain.

POLICY PROCEDURES

Selling your insurance policy can make sense if you don't want to keep paying hefty

premiums or if you would like more cash flow. *How to go about getting a good deal...*

- **Ask your insurance agent, attorney, or accountant.** If he/she isn't familiar with this market, and can't make a referral to an experienced professional, contact the Life Insurance Settlement Association, (www.lisassociation.org, 407-894-3797) for a list of member companies.

- **Check references.** Before working with an unknown party, ask to be put in touch with some satisfied clients.

- **Check compensation.** Any fee or commission should be paid by the buyer, not by the seller.

- **Check the bids.** Always ask that bids be submitted on the stationery of the ultimate buyer, not an agent or broker, to make sure that you're seeing the actual offer from the purchaser.

- **Protect your privacy.** In some transactions, an unrelated third party is brought in to hold the buyer's funds in escrow. Then your insurance policy can be placed in escrow and the sale can be concluded.

Done properly, such a process can ensure that the money really is available and your identity is not revealed widely. ■ ■