

LIFE INSURANCE

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Business Uses For Life Settlements

By Robert Finfer

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In today's lingering tough economic environment, the percentage of top executives joining and leaving a corporation is higher than the level seen only 10 years ago. Because a growing number of companies are being bought, sold, merged, and going bankrupt, many fail to recognize the value of a departing executive's key-person or split-dollar insurance policy, or the insurance purchased as part of a buy-sell agreement.

Here is where a good life insurance



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producer can help. Using a life settlement, many corporations have the chance to turn what previously was an "illiquid" asset on a balance sheet into something that immediately can add revenue to the company's bottom line.

Proceeds to Defray Expenses for Departing Executives

Using a life settlement, a corporation can recoup its past investment in the premiums and, if paying a severance package to an executive in the case of a merger or acquisition, use the proceeds to defray expenses that otherwise would drain the company's cash flow.

In the past, the only cash-out option available to corporations for prematurely departing executives (those not retiring) was to allow their key-person life insurance or split-dollar life insurance policy to lapse and collect the cash surrender value, less the lapse forfeiture that is often part of the contract. With a life settlement option, corporations can receive a significantly greater payout.

Insurance for Key-Person, Split-Dollar, And Buy-Sell Agreements

Before looking at the life settlement option, let's review key-person, split-dollar, and buy-sell agreements and how they work.

Key-Person Insurance

Key-person life insurance is purchased by the organization on the life

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of a key employee. The organization is the beneficiary and the proceeds usually are earmarked to repurchase the executive's shares from his estate when he dies, or to replace cash flow for the organization until the deceased executive is replaced.

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Split-Dollar Insurance

Split-dollar life insurance is purchased by the organization for the benefit of a key executive to provide cash flow for the executive when he retires. The goal of this non-qualified retirement plan is to maximize premium payments to maximize cash value. At retirement, the executive can borrow against the cash value, repay the organization the "advanced premiums" (which are expected to be significantly less than the increase in the cash value), and retain the additional cash to invest for additional retirement income. Alternatively, the executive may borrow only enough to pay the "advanced premiums" and allow the cash value to continue to grow for a while, eventually borrowing against it as retirement income, or perhaps using the loan proceeds to buy an annuity. The policy's eventual beneficiary is the executive's estate, whether he dies before or after retirement. If he dies before retirement, the proceeds belong to the organization to the extent of the "advanced premiums," and the remainder belongs to the deceased's estate (hence the name, split dollar).

Buy-Sell Agreement

The owners of some privately owned organizations purchase life insurance on their co-owners' lives to fund a buy-sell agreement between the parties. If one owner were to die, the proceeds of the policy would be paid to the other owner(s) and be used to redeem the ownership interest from the deceased's estate. Whereas this asset may not appear on the balance sheet of the organization, it usually is financed out of the organization's operating funds.

Note: Sometimes the key-person insurance, or the insurance purchased to fund the buy-sell agreement, is not a universal or whole life policy and, therefore, does not build any cash surrender value. Such a policy may be eligible for a life settlement transaction anyway, particularly if there is the option to convert the policy from term life insurance to universal or whole life insurance.

Conversion options usually expire after the passage of a stated time, so corporations should be aware of the pending expiration and investigate the possibility of a life settlement transaction before that date. If the insured meets the requirements for such a transaction, it would be prudent to convert the policy from term to whole life or, preferably, universal life. The corporation still may be able to sell the policy and generate funds to recoup its premiums paid.

What Are Life Settlements?

A life settlement is a cash payment to the owner of a life insurance policy

for an amount greater than the cash surrender value in exchange for the policy ownership. With the change in ownership, the life settlement company becomes the new beneficiary and is solely responsible for all future premiums to keep the policy in effect.

The life settlement option is available to private individuals as well as corporations that have a key-person or

"The life settlement option is available to private individuals as well as corporations that have a key-person or split-dollar policy they want to sell."

split-dollar policy they want to sell. Most life settlement companies are interested in buying only life insurance policies with face amounts of \$250,000 or more (the average face value of a key-person or split-dollar policy is \$1.3 million).

The amount paid to the policy owner depends on many factors, including the insured's age (most life settlement companies require that the insured be over 65) and health, the cost of the ongoing premiums to keep the policy in force, the policy's cash surrender value, the policy's face amount, and the existence of any loans against the cash surrender value.

The proceeds from a life settlement usually are tax-free up to the amount invested in the policy. The difference between that amount and the cash surrender value usually is taxable as ordinary income. Any amount above that usually is deemed to be capital gains. As with private individuals considering a life settlement, business owners should consult their tax and financial advisers before completing a transaction to determine the tax effect on the company resulting from the sale of a key-person or split-dollar policy to a life settlement provider.

The application for a life settlement is done in much the same way as the application for life insurance. It asks for information about the insured's medical history, current medical condition, medications, tobacco use, and activities of daily living. It also asks for the names and addresses of attending physicians and medical facilities, dates, and reasons seen. Unlike life insurance, for a life settlement no current exam is required.

Case Studies

Key-Person Insurance

Client: 70-year-old male

Face amount: \$3,000,000
Policy type: universal life
Cash value: \$0
Paid to client: \$210,000

The annual premiums of \$75,000 were far too expensive for the client to maintain this policy. He had used the policy for a buy-sell agreement, but recently had retired. The policy had no value except for the death benefit. Before doing this, the client was looking for another option that would increase the policy's cash surrender value.

Split-Dollar Insurance

Client: 74-year-old male
Face amount: \$1,628,000
Policy type: universal life
Cash value: Client owed \$328,000 to the corporation for policy/safe harbor roll-out.
Paid to client: \$434,000

This client wanted to leave the policy in a trust he had set up for charity. Learning about the life settlement option from his adviser, he pursued that option and used the proceeds to pay back the corporation and take the excess cash. He left the cash in the trust to pay for other charitable giving.

Buy-Sell Insurance

Client: 67-year-old male
Face amount: \$500,000
Policy type: universal life
Cash value: \$0
Paid to client: \$47,000

This client received the policy as part of a buy-sell agreement; the premiums were illustrated to continue until maturity, at an annual cost of \$15,000. The client decided to discontinue the policy because he already had a suitable personal policy to cover his needs.

Finding a Reputable Buyer

When considering a life settlement transaction for corporate clients, producers should use caution in identifying buyers. Reputable companies use institutional funding that provides assurance to sellers and buyers. In addition, because a growing number of states are requiring life settlement companies to be licensed, life producers also should check a prospective buyer's credentials and compliance with state licensing. Producers also should take a close look at their internal compliance programs and records of exercising strict business standards to protect their customers.

Conclusion

There are clear reasons for corporate executives to consider the life settlement option, so that with the producer's help, they can turn an "illiquid" asset into revenue.

