Life Settlements: Know When to Hold and Know When to Fold

A Professional Advisor's Guide to the Life Settlement Decision-Making Process

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Abstract: In the final analysis, a life settlement is a diversion of what often is the single most valuable financial asset a client's family or business might receive at an insured's death. It is therefore critical that all parties to the potential transaction follow a recognized set of "best practices" to ensure that a professional's "green light" or suggestion to proceed with a life settlement is the appropriate choice. Best practices here dictate a formal, objective, and documented two-part decision-making process to answer the question, "Should my client retain currently owned insurance or should it be sold?"

Introduction: Why Attorneys, CPAs, Trust Officers, and Others Need to Have a "Hold versus Fold" Process

We've all seen the marketing materials exclaiming, *"Mary Settler received a $1.5M life settlement for a $6M trust-owned policy insuring her life when the cash surrender value of the policy was only $650,000!"*

What a deal! Or *was* it?

How would you expect Mary's beneficiaries (or a jury) to react if two years after the trust sold her $6 million policy Mary unexpectedly died, even though everyone *thought* she still had years to live when the policy was settled?

The trust beneficiaries will want to know why the trustee sold the policy and only received the net (after settlement brokerage fees, income taxes, probate costs, and attorney's fees) from the $1.5 million life settlement (probably closer to $1 million), when in fact they could have received a $6 million tax-free, probate-free death benefit had the policy been kept in force. Pretty quickly, they are likely to ask the trustee, Mary's attorney who "green lighted" the transaction, her life settlement agent advisor, the agent's broker-dealer, and the life settlement broker, "Why did you allow this to happen?"[1]

Now these advisors need to have a logical, defensible, and hopefully documented answer to this entirely reasonable and predictable question.

Other factors to be considered are regulation and legislation. The life settlement market has grown at exponential rates over the last few years. As the marketplace continues to grow, so have reports of abuses. As a result, state insurance regulators have shown their commitment to deterring those

threats by providing stringent model legislation that is presently being implemented in many state legislatures.[2]

Another factor—and perhaps an even more important reason than the threat of lawsuits or violation of state law—is that a hold versus fold analysis prior to life settlement is the ethically and professionally responsible thing to do. A client is owed both a moral and legal duty by his or her advisors to use a process by which they ascertain whether or not the divestiture of life insurance from the named beneficiary to a group of investors is the *right* course of action.

The goal of this article is to help CPAs, attorneys, trust officers, financial planners, life settlement agents and brokers, broker-dealers, registered representatives, and other professional advisors construct an objective analytical framework when a life settlement is proposed to a client, in order to help answer the question of whether to hold (retain) or fold (sell) a life insurance policy.

The Hold versus Fold Decision-Making Process—Planning Analysis

Now that the need for a comprehensive life settlement decision-making process has been established, let's explore its two essential parts, planning analysis and economic analysis.

Planning Analysis

Unlike the economic analysis discussed further in this article, which focuses on the question of whether the sale of a life insurance policy for a given price makes good economic sense and results in a gain rather than a loss to the seller/seller's family/business, the planning analysis focuses on answering this preliminary question: "Given a particular client's needs, attitudes, and circumstances, is a life settlement even a viable option to consider?"

As an analogy, it is irrelevant for someone to compare and analyze prices of airline tickets if there is an easier, faster, and more convenient means of travel or if that person is simply afraid of flying. The ultimate goal of the planning analysis phase of a hold versus fold analysis is to determine the threshold question of whether a life settlement should even be considered.

What follows is a checklist of the types of questions an advisor should have the client answer prior to engaging in an economic analysis of any life settlement offers.

Life Settlement Planning Analysis Checklist: Should I Pursue a Life Settlement?

Step 1: Evaluation of Personal Needs and Attitudes
- Why did I originally buy the life insurance?
- How have my personal, estate planning, or business needs changed since then?
- How will my beneficiaries feel about my selling the life insurance death benefit they would otherwise receive?
- Is there some reasonable way I can continue to pay the premiums on my own?
- Do I have a current need or reasonably anticipate a future need for life insurance?
- If I sell this policy, will I be able to acquire additional insurance if a need I currently do not anticipate arises in the future?
- Am I still insurable from a medical underwriting standpoint?
- Am I still insurable from a financial (net worth) standpoint?
- Am I comfortable with a third-party financial institution (strangers) owning a significant amount of insurance on my life (and having no control over to whom those investors may sell the policy on my life)?
- Am I comfortable knowing I (or some designated relative or friend) may be contacted as often as perhaps once a month by someone tracking to see if I am still living?
- Will the receipt of life settlement proceeds reduce or eliminate Medicaid or other government benefits?
- Are there tax implications or other downsides to a sale of my policy that I may not be aware of?

Step 2: Alternatives to a Life Settlement
- Is another family member (e.g., a beneficiary) willing and/or able to pay the premiums on the policy if I can't or no longer want to? Would my named beneficiary be able and willing to make loans to me to help me pay the premiums?
- Are other nonforfeiture options available (policy loans, a paid-up reduced death benefit, or extended term) to relieve me of the burden of premium payments but still allow me to keep the policy in force?
- Is an accelerated death benefit available?

- Can a Section 1035 exchange solve my problem and meet my goals better than a life settlement?
- What are my options for third-party premium financing (i.e. can I keep the policy in force by borrowing from a bank or other commercial lender)?
- What are my options for "policy rescue" programs when (and if) such programs become available?[3]

The Hold versus Fold Decision-Making Process—Economic Analysis

Once the insured/owner and his/her advisors have decided it is appropriate to consider a life settlement and an offer has been received, what are the important variables? What data is necessary to project a conclusion as to the financial consequences of the life settlement transaction?

Required Data

In order to properly analyze the hold versus fold decision from an economic point of view, certain variables must be defined. The key data necessary to properly compare holding a policy until the insured's death versus folding it into a life settlement consist of:

1. An in-force policy illustration (based on stipulated assumptions for interest or dividends) that projects the premiums (carrying cost) necessary to continue the insurance coverage to a specified age[4]
2. Tax information (projected income, gift and estate tax rates)
3. Current information on policy ownership and beneficiary, current policy values, and policy loans (if any)
4. Life expectancy (LE) assumption calculations[5]
5. A reasonable expected average rate of return (ROR) on the client's investments, i.e. an assumed discount rate[6]

Of course, the life settlement offer itself is also a variable that needs to be obtained from several life settlement providers prior to any analysis.

Conceptual Issues

A client's advisors must consider the intrinsic economic value of retaining the policy until the insured's death in light of alternative life expectancy assumptions, and ultimately compare those values with the life settlement value. In addition to the data required to do the analysis, it is necessary to understand some basic actuarial concepts as they relate to the calculations themselves.

Net Present Value (NPV)[7]

NPV can be expressed as the future stream of costs and benefits converted into equivalent values today. In other words, NPV represents the present values of the client's costs and benefits and is sometimes referred to as discounted cash flow analysis.

Life Settlement Value (LSV)

The LSV is the value of the actual or estimated offer made by the life settlement provider after reduction by all applicable taxes. The LSV can be shown gross (before commissions) to make it readily comparable to other life settlement offers, or when the agent and broker do not yet know the amount of commissions, or (preferably) net (after commissions) to show what the client will actually receive from the provider.[8] There are also alternative ways in which any gain from the life settlement can be taxed. Gain equal to a policy's cash surrender value (CSV) in excess of basis is taxable as ordinary income. Gain in excess of the policy's CSV may also be taxable as ordinary income (i.e. the entire gain is taxed as ordinary income) or as capital gains (i.e. the excess gain is taxed as capital gains), and the advisor must be sure to take these methods into account when presenting the LSV to the client.[9]

The LSV calculation can be summarized as follows:
Life Settlement Value (LSV) = Life Settlement Offer – Commissions – Income Taxes (if any) – Estate Taxes (if any)

Intrinsic Economic Value (IEV)

The IEV illustrates the projected economic results to the client of continuing the policy and paying premiums for each year from the current year through the insured's assumed LE and for several years thereafter. The IEV is the value of retaining the policy until the insured's death.[10]

The cost of continuing the policy is the NPV of the total cash outlays required to maintain the policy. These consist of the current CSV (already a present value) plus the discounted value of remaining future premiums to be paid and income and gift taxes, if any. The NPV of the outlays should be calculated for each year of the insured's assumed LE and for several years thereafter.

The benefit of continuing the policy is the NPV of the policy death benefit, again calculated for each year of the insured's assumed LE and several years thereafter. As in the case of the life settlement, the death benefit may have to be reduced by estate taxes, for example, when the insurance is owned by the client individually and not by an ILIT. There would be no direct estate tax on the death benefit if the policy is owned by a third-party entity such as a corporation.

The IEV is then calculated by subtracting the NPV of the total outlays from the NPV of the death benefit. As one might expect, the IEV will be *greater* if the insured has a relatively short life expectancy because of the large spread between the NPVs of the death benefit and the cost of continuing the policy until the insured's early death. Conversely, the IEV will be less if the insured's life expectancy is relatively long because of the small spread (or even deficit) between the NPVs of the death benefit and the cost of continuing the policy until the insured's later death.

The IEV calculation can be summarized as follows: IEV = NPV of Insurance Death Benefit − Estate Taxes (if any) − Current CSV − NPV of Annual Premiums − NPV of Income and Gift Taxes (if any).

Comparing the LSV and the IEV

Comparing the LSV to the IEV at or around the insured's projected alternative life expectancies helps to answer the question of whether the client should hold or fold the policy from an economic point of view. If the LSV is less than the IEV, then the client should consider holding (retaining) the policy. If the LSV is greater than the IEV, then the client should consider folding (selling) the policy. Comparing LSV to IEV at or near the client's alternative projected LEs is the essential economic determinant of the hold versus fold decision. A professional advisor needs to conduct a hold versus fold analysis in *every* potential life settlement case, both to properly advise the client and to protect the advisor in case his or her advice is later challenged.

There are other important caveats concerning this type of analysis, including a particular sensitivity about choosing the appropriate assumed discount rate[11] and uncertainty about LE projections.[12] Also remember that this analysis is only relevant *after* the client has first answered the preliminary planning analysis questions in such a way as to make a life settlement still appropriate in the planning picture.

Case Study: Knowing When to Hold and When to Fold

Our case study involves the client situation discussed at the beginning of this article. Here are the key facts. Mary Settler, age 77, was the insured-grantor under a $6 million death benefit policy, owned by an irrevocable life insurance trust (ILIT), and premiums were funded via annual gifts and a trust side fund. The policy had $653,881 current CSV, and cumulative premiums paid to date were $844,111.

Because of changing financial circumstances, Mary no longer needed the insurance for estate planning purposes, so she contacted her attorney, life insurance advisor, and trustee, and asked them what her options were. At the first meeting with all her advisors, Mary answered the planning analysis questions in such a way as to make a life settlement a potential solution. Her insurance advisor solicited offers for the policy, and a life settlement provider offered to purchase the policy from the client for a net purchase price (after agent and broker compensation) of $1,490,000.

Step 1: Program Variables

Both the client and the trust beneficiaries wanted to be sure that the offer was in the family's best interests. The trustee, because of his fiduciary duty to determine the answer to this question, asked the insurance advisor to run the numbers. Assume the inputs in Table 1 [provided by Life Settlement NumberCruncher™ (LSNC), http://leimberg.com/products/software/LSNC.asp].

Step 2: Life Settlement Value

The second step in the economic analysis is to determine the LSV—the after-tax value of the policy to the client if it were to be life settled (Table 2). As previously mentioned, there is no definitive answer as to the proper income taxation of the gain from a life settlement (or whether policy basis equals cumulative premiums paid). Gain equal to a policy's CSV in excess of basis is taxable as ordinary income. Gain in excess of the policy's CSV may also be taxable as ordinary income (i.e., the entire gain is taxed as ordinary income) or as capital gains (i.e., the excess gain is taxed as capital gains).

In order to illustrate to the client and her advisors these alternative methods for potentially taxing life settle-

ment gain, the LSNC program illustrates taxation of this gain as all ordinary income or as eligible for capital gains (Table 2). In this case, although the CSV was $653,881, it did not exceed basis of $844,111 and, therefore, the entire gain would be taxed either as ordinary income or as capital gains. The program analysis showed that, assuming all ordinary income, the LSV was $1,231,644 (Table 2A, column 5), and assuming capital gains eligibility, the LSV was $1,360,822 (Table 2B, column 10). Note that

the LSV is already a present value so no discounting of these values is required. The opposite will be true for calculating the IEV, as next discussed.

Step 3: Intrinsic Economic Value

Next, the intrinsic economic value (IEV), the after-tax value of keeping the policy in force until death, is determined (Table 3). Based on an in-force illustration provided by the insurance company, the NPV of the

TABLE 1

Life Settlement NumberCruncher™

A. Key Data and Assumptions

Insured's name	Mary Settler		
Date of birth	July 28, 1930		
Current age (as shown on in-force policy illustration)	77		
Company name	ABC Insurance Co.		
Policy number	109876		
Current policy year	3		
Cash surrender value in current policy year	$653,881		
Insurance death benefit in current policy year	$6,000,000		
Life settlement offer (actual or estimated) after commissions	$1,490,000		
Cumulative premiums paid to date	$844,111		
Assumed Marginal Tax Rates	*Federal*	*State*	*Combined*
Gift	45%	0%	45%
Estate	0%	0%	0%
Ordinary income	35%	5%	40%
Long-term capital gains	15%	5%	20%
Assumed discount rate	6%		

	IRS Annuity Table	*IRS Table 90CM*	*Table 2001 CSO*
Life Expectancy (LE) Assumptions			
Projected life expectancy	11	9	11
LE assumptions by life settlement provider	#1 – 11.0	#2 – 10.0	#3 – 9.0
Life settlement provider average life expectancy	10		

B. Additional Data

Insured's Age	Calendar Year	Policy Year	Annual Premiums Paid	Annual Taxable Gifts	Insurance Death Benefit
77	2008	3	0	0	$6,000,000
78	2009	4	$245,000	$110,250	$6,000,000
79	2010	5	$245,000	$110,250	$6,000,000
80	2011	6	$245,000	$110,250	$6,000,000
81	2012	7	$245,000	$110,250	$6,000,000
82	2013	8	$245,000	$110,250	$6,000,000
83	2014	9	$245,000	$110,250	$6,000,000
84	2015	10	$245,000	$110,250	$6,000,000
85	2016	11	$245,000	$110,250	$6,000,000
86	2017	12	$245,000	$110,250	$6,000,000
87	2018	13	$245,000	$110,250	$6,000,000
88	2019	14	0	0	$6,000,000
89	2020	15	0	0	$6,000,000
90	2021	16	0	0	$6,000,000
91	2022	17	0	0	$6,000,000

TABLE 2

(Insured's Age—77; Calendar Year—2008; Policy Year—3)

A. Income Tax on Life Settlement

(1) Life settlement after commissions	(2) Cumulative premiums paid to date	(3) Gain on life settlement (1) – (2) but not <0	(4) CSV	(5) Ordinary income portion (4) – (2) but not <0	(6) Tax on ordinary income portion (5) x 40%	(7) Gain in excess of ordinary income portion (3) – (5) but not <0	(8) Tax on excess gain assuming ordinary income treatment (7) x 40%	(9) Tax on excess gain assuming capital gains eligibility (7) x 20%	(10) Total income taxes on life settlement (assuming all ordinary income) (6) + (8)	(11) Total income taxes on life settlement (assuming capital gains eligibility) (6) + (9)
1,490,000	844,111	645,889	653,881	0	0	645,889	258,356	129,178	258,356	129,178

B. LSV: Assuming All Ordinary Income

(1) Life settlement after commissions	(2) Income taxes on life settlement	(3) Life settlement after income taxes (1) – (2)	(4) Estate taxes on life settlement (3) x 0%	(5) LSV (3) – (4)
1,490,000	258,356	1,231,644	0	1,231,644

C. LSV: Assuming Capital Gains Eligibility

(6) Life settlement after commissions	(7) Income taxes on life settlement	(8) Life settlement after income taxes (6) – (7)	(9) Estate taxes on life settlement (8) x 0%	(10) LSV (8) – (9)
1,490,000	129,178	1,360,822	0	1,360,822

TABLE 3

Intrinsic Economic Value (IEV)

Insured's Age	Calendar Year	Policy Year	(1) CSV Year 3	(2) Annual Premiums Paid	(3) Annual Taxable Gifts after Side Fund	(4) Annual Gift Taxes (3) x 45%	(5) Total Annual Outlay (2) + (4)	(6) CSV + NPV of Total Annual Outlay (1) + NPV of (5) at 6%	(7) Insurance Death Benefit	(8) Estate Taxes on Insurance Death Benefit (7) x 0%	(9) Insurance Death Benefit after Estate Taxes (7) – (8)	(10) NPV of Insurance Death Benefit after Estate Taxes NPV of (9) at 6%	(11) IEV (10) – (6)
77	2008	3	653,881	0	0	0	0	653,881	6,000,000	0	6,000,000	5,660,377	5,006,496
78	2009	4	653,881	245,000	110,250	49,613	294,613	931,818	6,000,000	0	6,000,000	5,339,979	4,408,161
79	2010	5	653,881	245,000	110,250	49,613	294,613	1,194,022	6,000,000	0	6,000,000	5,037,716	3,843,694
80	2011	6	653,881	245,000	110,250	49,613	294,613	1,441,385	6,000,000	0	6,000,000	4,752,562	3,311,177
81	2012	7	653,881	245,000	110,250	49,613	294,613	1,674,746	6,000,000	0	6,000,000	4,483,549	2,808,803
82	2013	8	653,881	245,000	110,250	49,613	294,613	1,894,898	6,000,000	0	6,000,000	4,229,763	2,334,865
83	2014	9	653,881	245,000	110,250	49,613	294,613	2,102,589	6,000,000	0	6,000,000	3,990,343	1,877,754
84	2015	10	653,881	245,000	110,250	49,613	294,613	2,298,523	6,000,000	0	6,000,000	3,764,474	1,465,951
85	2016	11	653,881	245,000	110,250	49,613	294,613	2,483,367	6,000,000	0	6,000,000	3,551,391	1,068,024
86	2017	12	653,881	245,000	110,250	49,613	294,613	2,657,748	6,000,000	0	6,000,000	3,350,369	692,621
87	2018	13	653,881	245,000	110,250	49,613	294,613	2,822,258	6,000,000	0	6,000,000	3,160,725	338,467
88	2019	14	653,881	0	0	0	0	2,822,258	6,000,000	0	6,000,000	2,981,816	159,558
89	2020	15	653,881	0	0	0	0	2,822,258	6,000,000	0	6,000,000	2,813,034	(9,224)
90	2021	16	653,881	0	0	0	0	2,822,258	6,000,000	0	6,000,000	2,653,806	(168,452)
91	2022	17	653,881	0	0	0	0	2,822,258	6,000,000	0	6,000,000	2,503,590	(318,668)

future costs and benefits of keeping the policy in force is calculated at the assumed discount rate. In this case, these costs consisted of future premiums plus gift taxes resulting from taxable gifts. To determine the total costs of retaining the policy, the NPV of these future costs was added to the current CSV investment in the policy. Then, these NPV costs were subtracted from the NPV of the death benefit in any given year to arrive at the IEV, assuming the insured died in that year (Table 3, column 11). Note that, just as with the LSV, this column is a series of present value numbers and, thus, directly comparable in any year to the LSV.

Step 4: Comparison of LSV and IEV

The IEV is then subtracted from the LSV to arrive at the economic gain or (loss) from the life settlement (Table 4). The columns "Assuming All Ordinary Income" and "Assuming Capital Gains Eligibility" show the difference between these two values in any given year. The years showing negative numbers indicate a present value loss from the life settlement, assuming the insured dies in any of those years. (This illustrates the truism, "Life insurance is always a wise purchase—if the insured dies early.")

Consequently, in this case, it is better economically for the insured's family to *hold* the policy rather than to life settle it if the insured is assumed to die in or before year 10 (which is before any of the insured's projected alternative LEs). This is true whether the life settlement gain is taxed as all ordinary income or as eligible for capital gains treatment. However, there is a crossover point, at which the LSV becomes greater than the IEV, and the difference becomes a positive number. This indicates a present value gain from the life settlement, assuming the insured lives until the crossover year or beyond. In this case, a gain is first realized in year 11 of the policy, at age 85. Consequently, if the insured is assumed to live until that year, or any year thereafter, life settling the policy in year three (the current year) would be the better economic choice.

Note that the crossover point in this case occurs between years 10 and 11, prior to all of the four alternative LEs calculated in the program (see Table 1). This suggests that for this particular case, a life settlement is the better economic choice.

As stated previously, the discount rate chosen for the

TABLE 4						

Gain/(Loss) from Life Settlement

Insured's Age	Calendar Year	Policy Year	LSV Policy Sold		IEV Policy Held	Economic Gain/(Loss) from Life Settlement Difference (LSV − IEV)	
			Assuming All Ordinary Income	*Assuming Capital Gains Eligibility*		*Assuming All Ordinary Income*	*Assuming Capital Gains Eligibility*
77	2008	3	1,231,644	1,360,822	5,006,496	(3,774,852)	(3,645,674)
78	2009	4	1,231,644	1,360,822	4,408,161	(3,176,517)	(3,047,339)
79	2010	5	1,231,644	1,360,822	3,843,694	(2,612,050)	(2,482,872)
80	2011	6	1,231,644	1,360,822	3,311,177	(2,079,533)	(1,950,355)
81	2012	7	1,231,644	1,360,822	2,808,803	(1,577,159)	(1,447,981)
82	2013	8	1,231,644	1,360,822	2,334,865	(1,103,221)	(974,043)
83	2014	9	1,231,644	1,360,822	1,887,754	(656,110)	(526,932)
84	2015	10	1,231,644	1,360,822	1,465,951	(234,307)	(105,129)
85	2016	11	1,231,644	1,360,822	1,068,024	163,620	292,798 ←
86	2017	12	1,231,644	1,360,822	692,024	539,023	668,201
87	2018	13	1,231,644	1,360,822	338,467	893,177	1,022,355
88	2019	14	1,231,644	1,360,822	159,558	1,072,086	1,201,264
89	2020	15	1,231,644	1,360,822	(9,224)	1,240,868	1,370,046
90	2021	16	1,231,644	1,360,822	(168,452)	1,400,096	1,529,274
91	2022	17	1,231,644	1,360,822	(318,668)	1,550,312	1,679,490

Crossover Point

NPV calculations can make a significant difference in the resulting values. The LSNC program contains supplemental calculations that allow a comparison of the gain or loss results at alternative discount rates. Table 5 shows, that in this case, the crossover point does vary based on different assumed discount rates. At the lowest discount rates shown, 3% and 4%, the crossover point is between years 12 and 13 and between years 11 and 12, respectively (again regardless of whether the life settlement gain is taxed as ordinary income or as capital gains). In the 3% example, this crossover is after the LE calculated by IRS Table 90CM, but still prior to the other three life expectancies calculated in the program, and in the 4% example, it is still prior to all four of the projected life expectancies (Figure 1).

Based on this analysis, the client's advisors decided that the best economic result would be to take the life settlement. The reason is the client was expected to live to at least her projected life expectancies, and the life settlement would produce a substantial present value gain assuming she did so.

TABLE 5

Gain/(Loss) from Life Settlement
Range of Discount Rates

A. Assuming All Ordinary Income

Discount Rate Percentage

Insured's Age	Calendar Year	Policy Year	3	4	5	6	7	8	9
77	2008	3	(3,939,718)	(3,883,706)	(3,828,761)	(3,774,852)	(3,721,952)	(3,670,031)	(3,619,062)
78	2009	4	(3,484,018)	(3,378,530)	(3,276,068)	(3,176,517)	(3,079,768)	(2,985,718)	(2,894,268)
79	2010	5	(3,041,592)	(2,892,785)	(2,749,695)	(2,612,050)	(2,479,596)	(2,352,095)	(2,229,319)
80	2011	6	(2,612,051)	(2,425,722)	(2,248,386)	(2,079,533)	(1,918,688)	(1,765,408)	(1,619,274)
81	2012	7	(2,195,022)	(1,976,624)	(1,770,949)	(1,577,159)	(1,394,476)	(1,222,178)	(1,059,599)
82	2013	8	(1,790,140)	(1,544,797)	(1,316,247)	(1,103,221)	(904,557)	(719,189)	(546,137)
83	2014	9	(1,397,049)	(1,129,580)	(883,198)	(656,110)	(446,688)	(253,457)	(75,070)
84	2015	10	(1,015,408)	(730,333)	(470,770)	(234,307)	(18,775)	177,776	357,100
85	2016	11	(644,882)	(346,441)	(77,981)	163,620	381,145	577,066	753,588
86	2017	12	(285,149)	22,685	296,102	539,023	754,901	946,778	1,117,338
87	2018	13	64,106	377,614	652,372	893,177	1,104,206	1,289,105	1,451,053
88	2019	14	190,355	527,518	819,423	1,072,086	1,290,691	1,479,719	1,643,042
89	2020	15	312,926	671,655	978,520	1,240,868	1,464,976	1,656,214	1,819,178
90	2021	16	431,927	810,250	1,130,040	1,400,096	1,627,860	1,819,636	1,980,771
91	2022	17	547,462	943,513	1,274,345	1,550,312	1,780,087	1,970,952	2,129,022

B. Assuming Capital Gains Eligibility

Insured's Age	Calendar Year	Policy Year	3	4	5	6	7	8	9
77	2008	3	(3,810,540)	(3,754,528)	(3,699,583)	(3,645,674)	(3,592,774)	(3,540,853)	(3,489,884)
78	2009	4	(3,354,840)	(3,249,352)	(3,146,890)	(3,047,339)	(2,950,590)	(2,856,540)	(2,765,090)
79	2010	5	(2,912,414)	(2,763,607)	(2,620,517)	(2,482,872)	(2,350,418)	(2,222,917)	(2,100,141)
80	2011	6	(2,482,873)	(2,296,544)	(2,119,208)	(1,950,355)	(1,789,510)	(1,636,230)	(1,490,096)
81	2012	7	(2,065,844)	(1,847,446)	(1,641,771)	(1,447,981)	(1,265,298)	(1,093,000)	(930,421)
82	2013	8	(1,660,962)	(1,415,619)	(1,187,069)	(974,043)	(775,379)	(590,011)	(416,959)
83	2014	9	(1,267,871)	(1,000,402)	(754,020)	(526,932)	(317,510)	(124,279)	54,108
84	2015	10	(886,230)	(601,155)	(341,592)	(105,129)	110,403	306,954	486,278
85	2016	11	(515,704)	(217,263)	51,197	292,798	510,323	706,244	882,766
86	2017	12	(155,971)	151,863	425,280	668,201	884,079	1,075,956	1,246,516
87	2018	13	193,284	506,792	781,550	1,022,355	1,233,384	1,418,283	1,580,231
88	2019	14	319,533	656,696	948,601	1,201,264	1,419,869	1,608,897	1,772,220
89	2020	15	442,104	800,833	1,107,698	1,370,046	1,594,154	1,785,392	1,948,356
90	2021	16	561,105	939,428	1,259,218	1,529,274	1,757,038	1,948,814	2,109,949
91	2022	17	676,640	1,072,691	1,403,523	1,679,490	1,909,265	2,100,130	2,258,200

The Outcome

Two years later Mary unexpectedly passed away. At that point, the trust beneficiaries wanted to know why the trust received only a partially taxable $1.49 million two years prior, when in fact it could have received $6 million tax free had the policy been kept in force. The client's advisors were able to answer this question by referring to the planning analysis checklist, filled out by the client prior to the life settlement, and the economic analysis report that each of them had placed in their client files at the time of the life settlement. A dispute with the beneficiaries (and perhaps even a lawsuit) was averted, and just as importantly, the advisors were confident that they had performed their duty to the client (now deceased) with the utmost care and professionalism.
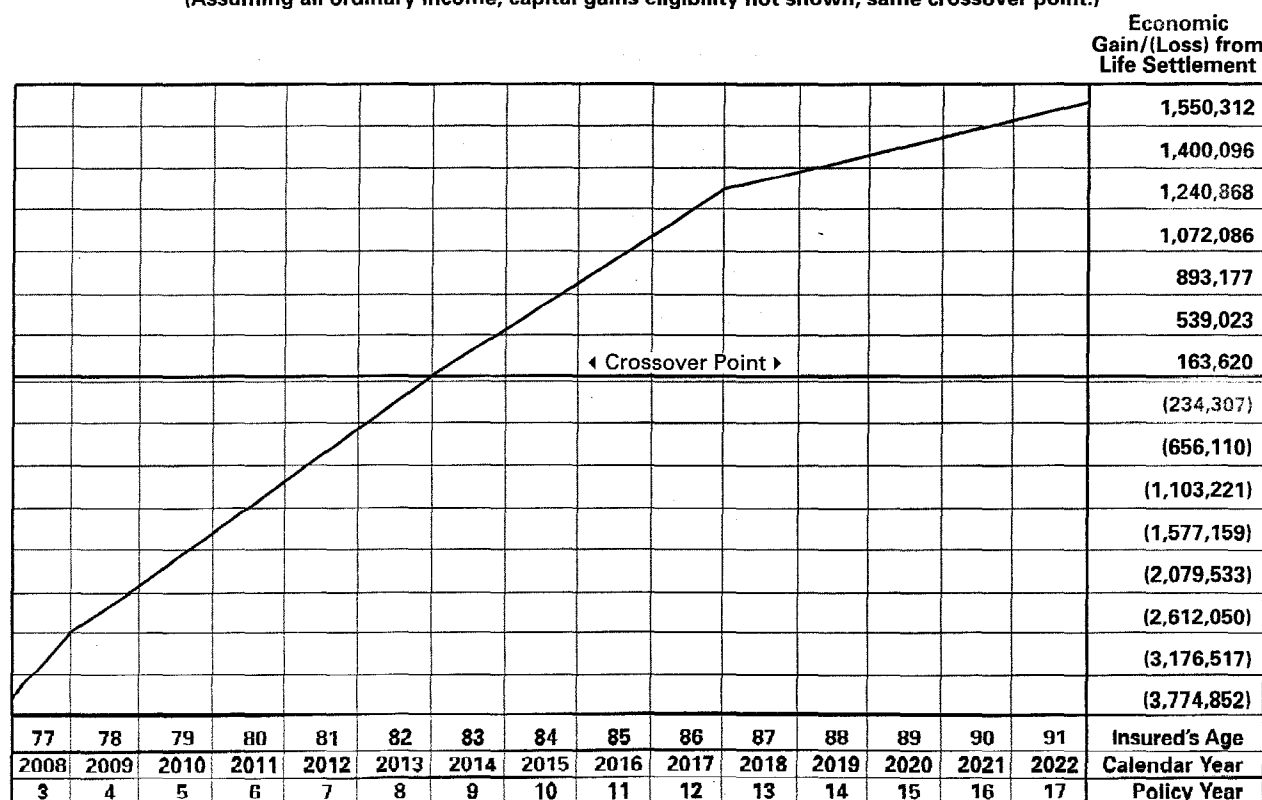
Conclusion

There are many issues that go into determining a proper course of action when considering a life settle-ment. An advisor can (and should) use the answers to questions about outside needs, emotions, attitudes, tol-erances, and unique circumstances to provide a more "refined" analysis *prior* to crunching the numbers. Once all questions as to the nonfinancial elements have been answered in such a way that a life settlement is still a potential solution, it is imperative that the client's advi-sors have in place a consistent, documented financial analysis process to answer the hold versus fold question.

Both types of analysis must be done in every settle-ment case in which the advisor is involved, both to prop-erly advise the client and to protect the advisor when, inevitably, the client later asks why a life settlement was *not* taken, or the client's beneficiaries ask why it *was.* What is important is that the process is objectively and diligently applied each and every time, so that there is a carefully and thoroughly reasoned answer to the ques-tion, "Should my client hold or fold?"[13] ■

FIGURE 1

Gain/(Loss) from Life Settlement
(Assuming all ordinary income; capital gains eligibility not shown; same crossover point.)

Economic Gain/(Loss) from Life Settlement

Insured's Age	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	Economic Gain/(Loss)
																1,550,312
																1,400,096
																1,240,868
																1,072,086
																893,177
																539,023
									◄ Crossover Point ►							163,620
																(234,307)
																(656,110)
																(1,103,221)
																(1,577,159)
																(2,079,533)
																(2,612,050)
																(3,176,517)
																(3,774,852)

	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	Insured's Age
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Calendar Year
	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	Policy Year

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APPENDIX

Life Settlement Economic Analysis Checklist

Is a Life Settlement Better Economically Than Retaining the Policy until Death?

- How long is the policy death benefit (DB) guaranteed at the current premium level?

- How long will this DB last, assuming current interest rates, mortality charges, and other expenses, if no more premiums are paid?

- Will I be required to pay additional premiums to maintain the DB until at least age 100?

- Given my current health, what is my projected LE or alternative LEs?

- What rate of return is reasonable to use when making an assumption as to earnings on investments (assumed discount rate)?

- What are the income tax consequences of selling the policy versus retaining it?

- What are the gift tax consequences of selling the policy versus retaining it?

- What are the estate tax consequences of selling the policy versus retaining it?

- How do I calculate the LSV of folding (selling) my policy, and the IEV of holding (retaining) it?

- How does the LSV compare to the IEV at my projected LE or alternative LEs (i.e., is there a gain or a loss from the life settlement)?

- How does the LSV compare to the IEV if I die before or after my projected LE or LEs (again, is there a gain or a loss from the life settlement)?

- Is my ultimate decision about whether to hold or to fold based on a carefully and thoroughly reasoned (and documented) analysis of how these two alternative courses of action will impact me *and* my family/business?

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(1) Of course, this question may come in the form of a lawsuit as opposed to a friendly telephone call!

(2) K. Kingma and S. Leimberg, "Deterring Stranger-Originated Life Insurance: Two New Model Life Settlement Acts," *Estate Planning Journal* (July 2008). Twelve states in the last year have adopted antiabuse statutes, mainly either the National Association of Insurance Commissioners (NAIC) or National Conference of Insurance Legislators (NCOIL) model acts, or in some cases a hybrid.

(3) A new company, Legacy Funding Group in Malvern, Pennsylvania, will lend money against a policy, and according to a spokesperson, the policy owner will be offered at least as much as could be obtained by selling it and possibly more. These so-called legacy loans are funded by lenders and investors who will pay all the premiums. Unlike a life settlement, because there is no sale, no tax is owed. At the insured's death, a portion of the policy proceeds are used to repay the loan (with 9% interest being charged). The heirs are paid anything that's left, with a minimum guarantee of 10% of the money. Legacy also structures arrangements with potentially rising death benefits. New York Life Insurance Co. offers a similar loan arrangement called Access Plus to its own policyholders in 22 states and the District of Columbia. In general, it is for people whose life expectancy is between 1 and 10 years. See J. B. Quinn, "Get a Life, Plus Cash, for Insurance Policy," www.bloomberg.com (June 18, 2008). These programs, and others like them, are said to be in their preliminary stages. They claim to provide alternatives to the secondary market for life insurance that could be more beneficial than a life settlement for a particular client because they may be able to provide access to immediate cash, allow the insured to keep a portion of the death benefit, retain ownership of the policy, and receive more preferential tax treatment than would be the case under a life settlement. A client should consider these types of policy rescue programs before selling a policy when (and if) they become available. *Note:* The authors do not endorse or recommend any specific financing program.

(4) This illustration will show the insured's current age, current policy year, annual premium, cash surrender value, and death benefit (face amount). It will be necessary to exercise judgment in determining the annual premium to use in the illustration. The authors suggest the following: for whole life, use the scheduled ("as-sold") premium. For guaranteed universal life (GUL) and "hybrid" variable universal life (VUL) having secondary guarantees until at least age 100, use the scheduled ("as-sold") premium. For regular (current assumption) UL and VUL, use the scheduled ("as-sold") premium unless this premium is insufficient to carry the policy until at least age 100 at the current face amount (as shown by the illustration). If the policy will not carry to age 100 at the current face amount, determine a level annual premium based on the current crediting rate and other current assumptions that will do so. For term insurance that is near the end of its guaranteed term (the usual case with the life settlement

of a term policy), use the least expensive level annual premium for a GUL or regular UL policy that is available on conversion of the term to carry the policy until at least age 100 at the same face amount as the term. Note: A life settlement provider may request a separate in-force illustration that is different from the illustration requested by the client. The provider will usually take an aggressive approach and want an illustration that shows the minimum annual premium required to carry the policy to age 100. On the other hand, the client may adopt a more conservative approach and select a higher premium for the client's illustration that will be more likely to carry the policy until at least that age and ensure that the policy does not expire before the insured does.

(5) The insured's LE is crucial to a life settlement provider in determining the amount of a life settlement offer. Obviously, it is impossible to predict the precise year in which the insured will die. Consequently, any hold versus fold economic analysis should consider two or more alternative LE calculations for projecting the insured's LE. This enables the client's advisors to consider the intrinsic economic value of retaining the policy until the insured's death in light of these alternative LEs and ultimately compare those values with the life settlement value. In Life Settlement NumberCruncher™ (LSNC), a software program created by the authors to facilitate the hold versus fold decision-making process (www.leimberg.com), the authors suggest a spread of at least four calculations. The first life expectancy calculation is made under the IRS annuity table (identified as IRS Annuity Table in the program). This table is used to determine the tax-free portion of an annuity under Section 72 of the Internal Revenue Code. It is gender neutral (unisex) and is based on the insured's nearest age. The second life expectancy calculation is made under IRS Table 90CM (identified as IRS Table 90CM in the program). This is the IRS valuation table used in valuing such estate planning tools as grantor-retained income trusts (GRATs and GRUTs) and charitable remainder trusts (CRATs and CLUTs), and it should be familiar to sophisticated advisors. This table is gender neutral (unisex), and is based on the insured's nearest age. The third life expectancy calculation is made under the Commissioners 2001 Standard Ordinary Mortality Table (identified as 2001 CSO in the program). This table is commonly used in life insurance computations. It is gender specific and is based on the insured's attained age. The fourth life expectancy calculation is made by the life settlement provider (identified as Provider Average LE in the program). This LE will usually consist of several life expectancies received by the provider from life expectancy companies, and the program averages those LEs. All LEs are rounded to the nearest whole year.

(6) The assumed discount rate is the rate used in determining NPV calculations throughout the LSNC model. This rate can be defined as the rate of return the client expects to earn from the client's investments [see Ibbotson, *Stocks, Bonds, Bills and Inflation® Valuation Yearbook*, Chapter 2 (Ibbotson Associates 2004)]. Ideally, calculations would take into consideration discount rates above and below the assumed rate to show best and worst case scenarios.

(7) There is an alternative method that could be used to make this analysis—a net future value (NFV) analysis. With an NFV analysis, the LSV is accumulated at the assumed interest rate (the same rate as the assumed discount

rate). Next, the future cash outlays for future premiums and income and gift taxes (if any) plus the current cost of keeping the policy, i.e., the current cash surrender value, are also accumulated at the same rate. The NFV of the costs is then subtracted from the future benefits, i.e, the policy death benefit (already a future value) to arrive at the IEV. Then, because the LSV and the IEV are both now on a future value basis, the LSV can again be compared with the IEV to determine if there is a projected gain or loss from the life settlement. In short, an NFV analysis is just the flip side of an NPV analysis, and either analytical method is valid. However, each method has its own distinct calculations, present values for NPV, and future values for NFV, and it would be an error to attempt to combine these two different analytical tools. Most financial modeling is done on an NPV basis.

(8) We strongly believe that the life settlement offer *after* commissions should be included in the model that is ultimately used by the client in making the decision whether to hold or fold (i.e., to retain or sell the policy) because it bases the results on what the client will actually receive net. If the actual amount of the life settlement offer is known (whether before or after commissions), it should be used. If the actual amount is unknown at the time, an estimated amount may be used initially. In that case, the advisor should inform the client that the life settlement offer is an estimated amount, and he or she should rerun the calculation when the actual amount becomes available. A note on commissions: Life settlement providers represent buyers, and as such are not required by current or pending law in most states to disclose their compensation. Providers make gross offers to brokers, who represent sellers. Agents and brokers do take commissions, and thus they should disclose to their clients all compensation in the agent-broker "food chain," including the amounts paid the agent transacting the settlement, the agent's life settlement broker, and any other broker involved in the transaction. They should also disclose whether compensation is uniform with each provider (i.e. if there is any incentive to push business to any particular company). Clients should ask to see all offers made, including the gross offer, and all compensation paid, while at the same time keeping in mind that this a very technical, time-intensive, and complex transaction that can create tremendous value. While many brokers are quickly moving toward full compensation disclosure, in states where there is no life settlement statute, most do not disclose compensation at all, or if they do, disclosure is made of only the agent-level compensation. Some reveal the dollar amount of their compensation (typically 6%–10% of death benefit) while others do so as a percentage of the offer (up to 30% of the gross offer). Another method is to charge a flat fee of from 10% to 50% of "value created" (i.e. life settlement offer in excess of cash surrender value). Both of the new legislative model acts (NAIC's Amendments to the Model Act and NCOIL's Life Settlement Model Act, some form of which is currently pending in over 20 states) require full disclosure by brokers of all offers and compensation by method and amount.

(9) Ordinary income: The initial amount of gain is the excess of the policy's CSV over the policy owner's basis. This amount will be taxed as ordinary income. Capital gains: Many practitioners believe any gain in excess of CSV is due to "market forces" and will therefore be taxed as long-term capital gains (based on the assumption that the policy is a capital asset and has been held for more than a year). It is important to note that this belief is primarily predicated on the opinion of a national accounting firm and has no official Code or IRS sanction. Accordingly, the calculation should illustrate the alternative taxation of the gain in excess of CSV as either ordinary income or capital gains so the client and advisors can make decisions based on both possibilities. There is also some question as to whether basis, generally thought of as total premiums paid reduced by the sum of tax-free dividends and other tax-free distributions (referred to here as "cumulative premiums paid"), must also be reduced by the cost of the insurance protection (COI) provided by the policy. Many practitioners believe policy basis equals cumulative premiums paid. This conclusion is supported by the opinion mentioned above. But it should be noted that this position also has no official Code or IRS sanction. In fact, the IRS has taken the position in several private letter rulings that basis must be reduced by COI charges. These rulings have been criticized by commentators as incorrect, and as private rulings, they have no precedential value. So, in doing the calculation, a practitioner may want to run the numbers both ways, first assuming basis equals cumulative premiums paid and again assuming a reduction by the cost of insurance. For more information about the income taxation of life settlements, see J. Magner and S. Leimberg, "Life Settlement Transactions: Important Tax and Legal Issues to Consider," *Estate Planning* 3 (April 2007): 8–10. Estate taxes: Estate taxes may also be imposed on the life settlement at the client's death. For example, this would be the case where the policy is owned by the client individually and not by an irrevocable life insurance trust (ILIT). In that situation, the settlement proceeds received by the client and retained until the client's death would be subject to estate taxes. Of course, if the policy is owned by an entity such as a corporation, there would be no direct estate tax on the life settlement proceeds received by the corporation.

(10) Please note that the IEV does not determine the actual amount or value of a life insurance policy. It is an academic and mathematical valuation.

(11) The NPV discount rate assumed in calculating the IEV is very important because it determines the NPVs of the client's costs and benefits. As previously indicated, the discount rate can be defined as the rate of return the client expects to earn from the client's investments (see Ibbotson, *Stocks, Bonds, Bills and Inflation® Valuation Yearbook*). Varying the discount rate can have a significant impact on the IEV and ultimately on the comparison of the IEV with the LSV.

(12) Ed Mohoric and Robert O. Kinney, "Life Settlement Mortality Considerations and Their Effect on Portfolio Valuation," *Milliman and Phoenix Life Solutions,* Section III (March 1, 2008): 7–8.

(13) There are many excellent articles that cover other elements of the life-settlement process. For further information, we recommend the following sources: J. Magner and S. Leimberg, "Life Settlement Transactions: Important Tax and Legal Issues to Consider," *Estate Planning Journal* (April 2007): 3–12; "Cash in on Your Life," Kiplinger Magazine (June 10, 2008); "Six Things to Consider When Evaluating Life Settlement Opportunities," *The Advocate* (Valmark Securities, Inc.,2007), www.valmarksecurities.com.

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