Robin & Peter on LIFE SETTLEMENTS

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Retained Death Benefit Life Settlements: Uncertainties That Need To Be Considered

Much has been written about retained death benefit life settlements, where the policy owner does a life settlement but, in addition to or in lieu of cash, retains a contractual right to some portion of the death benefit. While these arrangements can be beneficial for a policy owner that really needs to keep some death benefit in force, there are certain risks to these transactions that should not be ignored, yet they are rarely discussed.

It is most important that clients understand that all they are getting is a contractual promise by the purchaser to keep the policy in force and pay a portion of the death benefit to the seller. If the buyer becomes insolvent and does not keep the policy in force, the seller can be out of luck.

There are usually certain contractual protections for the seller, primarily involving the right to notice if the policy is going to lapse and to take over the policy and keep it going. But the practical efficacy of these protections is questionable. Remember that the insurer is not required to allow reinstatement if the policy has already lapsed after the expiration of the grace period. Will the seller realize the policy is in jeopardy in time to save it? Given that the policy may have been sold because the premiums were becoming unaffordable, will the seller have the cash ready to keep the policy going?

Buyers typically pay premiums at levels they predict will maximize their return upon death. Producers who have sold life settlements routinely receive notices that the buyers are not paying the "planned" or billed premium or that the policy is about to lapse. Furthermore, where a buyer routinely pays during the grace period, how is one to know if this is the one time that the buyer will fail to pay in time?

While the buyer may offer an irrevocable beneficiary arrangement, this does not solve the lapse problem. Moreover, it can create new ones. An irrevocable beneficiary

arrangement is just that, irrevocable. The seller must choose the beneficiary at the time the transaction occurs and it cannot be changed. So a change in the relationship with a named beneficiary cannot be remedied by simply naming a new beneficiary.

Another consideration for sellers to be aware of is that the income tax consequences of these arrangements are uncertain and because the specific terms of these transactions do vary, the tax consequences can differ from deal to deal. While Rev. Rul. 2009-13 answered some questions about the income tax treatment of life settlements to sellers, these alternative arrangements were not specifically addressed. There are many possible ways a retained death benefit transaction could be taxed, most of which are not particularly favorable to the seller.

The ongoing death benefit could be treated as split dollar under the economic benefit regime. This approach could mean significant taxable income when considering the advanced age of most life settlement insureds.

Another option could find the IRS valuing the retained death benefit like receiving a paid up policy or taking the present value of the expected cost to provide the retained death benefit. Under either approach, adding the sum to the seller's proceeds at the time of sale, if any, could create a large tax bill.

Yet, another approach could have the IRS treat the cost of the ongoing death benefit as some form of annuity and tax the transaction that way or the IRS could treat the retained death benefit as a loan to the seller that comes due upon death. What compounds the problem is that the seller may not have enough cash to handle the tax bill since many retained death benefit transactions involve little or no immediate cash going to the seller.

Finally, the buyer may be offering up a retained death benefit just because they cannot compete against cash offers that may be available. Don't get distracted by this negotiating tactic unless the policy owner really needs the death benefit and has been apprised of the risks.

Typically, insurers are not contractually required to and therefore will not permit a policy to be split up, with part being sold and part being retained. Life settlement arrangements that provide for a continued, but reduced, death benefit for the seller can be a creative alternative for a policy owner that wants to retain some, but not all, of their coverage.

The complexities, risks and uncertainties of these transactions, however, require that they be evaluated carefully prior to making a decision. Your clients need to be able to determine if the reward outweighs the risks. Our expertise in both life insurance and life settlements can help you and your clients make an informed choice.

Contact us:

Robin S. Weinberger, CLU, ChFC, CLTC

(617) 451-3343

Peter N. Katz, JD, CLU, ChFC

(860) 673-3642

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