Operational, Legal and Tax Issues in Life Settlement Transactions

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Abstract

The life settlement industry brokers the transfer of rights in life insurance policies from policyholders to investors. In this article, we examine life settlement transactions from the standpoint of the investor. We discuss the history and current state of life settlement structure, regulation and taxation. Although recent tax and legal rulings as well as industry challenges have reduced life settlement market activity, the benefits of these transactions persist for market participants. Over time, we expect life settlement activity—in one form or another—to reestablish growth as investors get resolution on regulatory questions and taxation and as the life settlement industry attempts to refurbish its tarnished reputation. This evolving situation may lead life insurers to develop new alternatives of their own.

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Introduction

The life settlement industry originated about 30 years ago as a market mechanism to pay the medical expenses of AIDS victims who owned life insurance. The procedure is straightforward: The ailing insured transfers his insurance policy to investors in return for an immediate cash payment negotiated by a settlement broker.\(^1\) The investors receive the contractual policy payoff upon death of the insured.

Life settlements occupy an awkward position in the U.S. insurance industry. On the one hand, life settlements are mostly legal, and they offer financial benefits to the direct participants: the insureds, the investors and the settlement brokers. On the other hand, life insurers and regulators often oppose life settlements, and the public feels uncomfortable with a business model based upon the expectation of imminent death. In addition, weak regulation and shady practices by some settlement brokers have undermined industry efforts to achieve acceptance and legitimacy.

In this article, we begin by providing some basic information about life settlements and the life settlement industry. Next, we discuss recent legal and tax rulings and other challenges that have impacted the settlement market. Finally, we conclude with a brief discussion of what the life settlement market might experience in the future. By exploring the history and current conditions of the life settlement market, we hope to deepen understanding of life settlements and suggest how this innovative mechanism may evolve to serve market participants in the future.

Three Kinds of Life Settlements

We may distinguish three major overlapping types of life settlements: viaticals, pure life settlements and stranger-owned life insurance (STOLI). The original version of the life settlement device that emerged during the early years of the AIDS crisis became known as a viatical settlement.\(^2\) In a viatical settlement, the insured is known to suffer impaired health and has an ascertainable medical prognosis with a limited life expectancy.

In a pure life settlement, the demise of the insured is generally not so imminent. The insured may be healthy but have limited prospects on account of advanced age, or the insured may suffer impaired health with only somewhat shortened life expectancy. The distinction between viatical and pure life settlement is not sharp. Some sources define the two types of settlements on the basis of a

\(^1\) According to a Securities and Exchange Commission (SEC) report, the right to transfer ownership of a life insurance policy dates back to the 1911 Supreme Court case Grigsby v. Russell in which the Court ruled that life insurance carries the same characteristics as any other property (SEC, 2010).

\(^2\) Quinn (2008), p. 762, attributes the origin of the term viatical to Richard Bandfield, a financial planner for the terminally ill. The ecclesiastical meaning of viaticum is a Eucharist for a terminally ill person. To the ancient Romans, viaticum meant a travel allowance for public officials.

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rather arbitrary cut-off for life expectancy of the insured, such as two years or less for viaticals. Other sources do not clearly distinguish the two types but use “viatical” and “life settlement” interchangeably. An insured may also seek a life settlement for reasons other than health. For example, the original beneficiaries may have died or become alienated from the insured through divorce. Sometimes a life insurance policy has been acquired for a key executive in a business arrangement that has lost its relevance over time. The economic principles are the same for viaticals and pure life settlements. However, the imminence of mortality and demand for funds to care for a policyholder in ill health make the parties to a viatical considerably more motivated.3

Stranger-owned life insurance (STOLI) is “a transaction in which an investor or their representative induces an individual, typically a senior, to purchase a life insurance policy that he/she likely would not otherwise have purchased” (SEC, 2010). In STOLI transactions, the intent is that the purchaser of life insurance will transfer ownership of the policy to a “stranger”—e.g., to an investor. The senior receives an immediate cash payment from the stranger, who expects to profit upon the insured’s death, as in other life settlements. The transfer takes place either immediately or after a contractual/statutory no-contest waiting period. The intent to transfer ownership soon after purchase distinguishes STOLI transactions from viaticals and other life settlements.

STOLI transactions have come under intense scrutiny. Recent court rulings and proposed regulation may jeopardize the future of this arrangement. Guttery, He and Poe (2012) analyze the regulation of life settlement transactions and STOLI, in particular. They suggest that the motivation for a STOLI transaction is largely the exploitation of an arbitrage transaction in which the underlying life insurance is mispriced. As a counter-strategy, they suggest that insurers reprice policies that are likely to be the objects of STOLI transactions. In addition, they suggest that insurers participate as buyers or capital providers in the life settlement market to hedge against decreased profitability from the lower lapse rates caused by life settlements.4,5 In this article, we focus on viaticals and life settlements, although some of our remarks also apply to STOLI transactions.

3. According to Gardner et al (2009), “[T]he average life settlement candidate is a 78-year old male who owns a universal life insurance policy valued at $1.8 million, and the average lump-sum payment ranges from two to five times the policy’s cash surrender value.”
4. A 2011 Delaware Supreme Court ruling allowed life insurers to challenge these policies. In New York and California, new laws effectively prohibit STOLI, but each state’s courts apply these laws only to policies effective after the legislation. See Byrnes and Bloink (2011) and Henderson and Tam (2011). Many new state laws have banned STOLI. Cole and McCullough (2008) review early STOLI legislation.
5. Concern even extends to the ChOLI (Charity-Owned Life Insurance) subclass of STOLI. In ChOLI, a charity shares with investors its insurable interest in an individual. ChOLI transactions are the subject of a U.S. Treasury report that recommends tightening the tax treatment of all secondary life insurance transactions involving a transfer of value. See Treasury Department (April 2, 2010).
The Life Settlement Industry

Even though there is a trade association for the life settlement industry (the Life Insurance Settlement Association), reliable data on the industry are difficult to obtain. The life settlement industry enjoyed rapid growth throughout most of its existence, but it has recently encountered reversals. According to a 2009 Conning study, the size of the life settlement market in 2008 was approximately $11.8 billion in settled policies. The Government Accountability Office (GAO) estimates that the face value of settled policies in 2008 was between $9 billion and $12 billion (GAO, 2010). SEC (2010) suggests that the market contracted to approximately $7 billion in 2009 on account of the financial crisis, and contracted further in 2010 as major market participants exited the market. Annin, De Mars and Morrow (2010) estimate that the five years preceding their article saw more than $40 billion of face value sold in the life settlement market. More recently, in its SEC filings, Life Partners (2013) estimates the 2012 life settlement market at about $2 billion in face value transactions, forecasting that the 2013 market would remain flat. However, the life settlement industry remains very small compared with the companies that originate life insurance.6

The Financial Attractions of Life Settlements

For a terminally ill insured, a life insurance policy represents a potential source of funds for medical expenses. However, policy restrictions typically constrain the owner’s realization of the full potential value during his lifetime. To be sure, most cash-value policies provide that the owner may borrow from the issuer. But such loans are limited to the cash value of the policy, and are not available for term life insurance, which has no cash value. Most policies also provide that the owner may surrender the policy to the issuer for a cash settlement. However, surrender proceeds are usually much less than the face value of the policy and may be subject to surrender charges and other fees. Consequently, the imminence of death and the payout due upon death of the insured confers a high present value upon all such policies for the insured and their family—whether the policy is a cash value contract or term insurance.

The differential between the surrender or loan value of the policy and the present value of the policy in a life settlement transaction creates an arbitrage opportunity. The life settlement industry has developed to capitalize upon that opportunity. By matching a willing policyholder with one or more investors, a settlement broker can engineer a transaction in which the parties benefit by splitting the differential among themselves. The ailing policyholder receives more

6. According to the American Council of Life Insurers (2012), life insurers reported total individual premiums in 2011 exceeding $101 billion on in-force individual policies with face value of about $11 trillion.
in the life settlement than he or she could receive from surrender; the investors receive an enhanced expected return in comparison with more conventional investments; and the settlement broker earns a fee for arranging the transaction. The terms of the split are subject to negotiation. Since there is no transparent organized market for settlements, the terms can vary across transactions.\(^7\)

However, the differential must be sufficiently large to accommodate the needs of all three direct parties. If the net proceeds to the ailing policyholder are less than the proceeds obtainable from surrender to the insurer, then a policyholder will generally prefer surrender over a settlement. The net proceeds must sufficiently exceed surrender proceeds to overcome policyholder reservations and uncertainties about the life settlement arrangement, which is probably unfamiliar to the policyholder. In order to earn an adequate return, an investor will discount his portion of the differential based upon the insured’s shortened life expectancy and his own requirements for return on investment. A longer life expectancy for the insured lowers the investor’s return on investment (ROI), leading to a higher discount. The settlement broker bears the costs of soliciting both investors and ailing policyholders, negotiating the terms of the transfer, and arranging details of the contractual relationships. The full intermediary expenses can be substantial. Since there is no public market for life settlements, information on broker fees and investor returns is difficult to obtain. According to FINRA (2009), commissions can be as high as 30 percent. According to Deloitte and the University of Connecticut (2005), an estimated representative fee of 23.5 percent breaks down as follows: about 6 percent for brokers, 5 percent for providers, 5 percent management fee and 7.5 percent sales commission.\(^8\) Still, after investor discounts and broker fees, the negotiated payout to the policyholder is usually substantially more than the surrender value of the original policy.

The immediately preceding paragraphs discuss a life settlement as though it were the sale of a stock certificate when, in fact, there are substantial differences between life settlements and stocks. One major difference is that life settlement transactions do not occur on traditional stock exchanges. Absence of an organized market and weak regulation create an information asymmetry that conveys considerable power to the settlement broker. The policyholder has almost certainly never before participated in a life settlement. The broker may have more experience and financial incentive to structure a favorable deal than the policyholder, who may lack the knowledge to pursue alternatives. Moreover, the arbitrage differentials are so lucrative that brokers have been tempted to solicit dubious settlement transactions with individuals who do not understand the

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7. For a thorough discussion of the benefits of a secondary market for life insurance, see Doherty and Singer (2003).
8. High commissions and fees may create additional incentives for fraud in a field already plagued by a lack of transparency for both sellers of policies and investors in these transactions. Brokers have an incentive to find insureds in poor health since this increases the potential returns to investors and may motivate sellers who find attractive the higher settlement offers that come with low life expectancy.

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consequences. This is the origin of STOLI. On the other side of the transaction, many investors desperately seeking high yields in a low-yield environment have little experience with life settlements, and ignore the risks. Life settlement yields are attractive. But brokers undoubtedly retain more of the arbitrage differential for themselves than they would in an organized market. Moreover, brokers have been accused of pressuring compliant doctors to certify low life expectancies of insureds in an effort to increase the attraction of settlements for investors. Brokers generally retain no residual interest in the settlement after it closes.

The arbitrage differential that sustains the life settlement industry exists at the sufferance of the life insurance industry. The life insurer stands to lose from the maturation of a life settlement. Without the transaction, many ailing policyholders would feel compelled to surrender their policies for whatever amount they could get, or even allow their policies to lapse through non-payment of premiums. With the transaction, the life insurer faces the near certainty of having to pay the full face value of the policy. Life insurers could eliminate the arbitrage differential by repricing their surrender values to their actuarially fair amounts. In a step in that direction, a few insurers have started to offer settlements that exceed surrender value. In effect, such insurers assume the role of investors in viaticals on their own policyholders—a transaction akin to a corporation’s buy-back of its own stock or its own debt. Some insurers have actually started to buy settlements or STOLIs directly as a hedge against losses from reduced lapses and surrenders (Richardson, 2005). Without competition from life settlements, life insurers can capture the full arbitrage differential for themselves. Therefore, it is not in the financial self-interest of life insurers to reprice their policies as long as life settlements remain relatively uncommon.

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9. Even the rich and famous who can afford professional advice are not immune. Former CNN talk show host Larry King alleged in a lawsuit that he had been misled into buying $15 million in life insurance and flipping it to “strangers” (www.themokinggun.com/documents/crime/larry-king-rooked-life-insurance-scam).

10. Insurers assume a certain percentage of policies will lapse and they use this assumption when building pricing and profitability models. Life settlement transactions create increased risk of lower-than-expected lapse rates among high-risk insureds, reducing insurer profitability.

11. In essence, a life insurance policy is a loan from a policyholder to the insurer, in which the premiums that the policyholder pays constitute periodic loans to the insurer that mature stochastically when the policyholder dies. It is our conjecture that insurers could repurchase those loans (policies) from ailing policyholders for less than the going settlement rate and thereby end the life settlement industry by undermining its economic foundation. The life settlement industry would not exist without the differential between surrender value and present value of the policy.

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Investor Risks

For a prospective investor, the brief description above belies some complicated analysis required in each transaction. For example, to determine an appropriate discount, there must be a medical evaluation of remaining life expectancy, with attendant uncertainties. There are agency risks. Settlement brokers commonly arrange for medical evaluation. The broker has an interest in obtaining a low estimate of life expectancy. Some viatical brokers have been sued for allegedly pressuring physicians to lowball estimates of life expectancy and/or for allegedly channeling medical evaluations to compliant physicians. Medical advances are an investor risk. The development of drugs that can convert AIDS from a death sentence into a chronically manageable condition have undermined the financial calculations on many viatical contracts. Provision must also be made for continued payment of life insurance premiums during the insured’s lifetime. At least one state attorney general sued and settled with a viatical broker for requiring investors to pay premiums in the face of contractual language that assured investors that there would be no additional levies. The agreements among the insured, the life settlement company, and the investors must be structured properly—and the forms of these agreements may have substantial legal and tax consequences.

The Regulation of Life Settlements

Based, in part, on prior scandals, the life settlement industry now supports regulation. Some settlement companies welcome legislation for the legitimacy that regulation confers—better to have some law to cite to potential customers than none at all. According to SEC (2010), at least 45 states have adopted some sort of legislation regulating life settlement transactions. The states generally draw on model legislation, in whole or in part, drafted by the National Association of Insurance Commissioners (NAIC) or the National Conference of Insurance Legislators (NCOIL). NAIC’s amended model legislation, the Viatical Settlements Model Act, was approved in June 2007; NCOIL approved its Life Settlements Model Act, was approved in June 2007; NCOIL approved its Life Settlements Model Act in November 2007.

12. For the theory of pricing of life settlements, see Brockett, Chuang, Deng, MacMinn (forthcoming).
13. For example, Maremont and Scism (2010) mention a settled Colorado case on these issues. Dr. Cassidy of Reno testified that Life Partners, the leading life settlement broker, referred to him about 100-200 cases per week for review, which he supposedly performed on a part-time basis. Dr. Cassidy of Reno testified that Life Partners, the leading life settlement broker, referred to him about 100-200 cases per week for review, which he supposedly performed on a part-time basis.
14. The payment of premiums on policies that persist longer than represented has been a focus of litigation among authorities, investors and life settlement brokers. Concern that Life Partners Holdings would run out of money to pay these premiums led the Texas Attorney General to seek a temporary restraining order that would preserve money needed to fund future premiums. A September 2012 state court ruling that life settlements are not securities effectively ended this suit.

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There is ample historical justification for regulation on account of evidence of fraud and abuse to which both policyholders and investors have been subjected. Absence of a sustained national market and lack of transparency create a huge information asymmetry in favor of the settlement broker. In addition, the immediacy of policyholder health needs produces a vulnerable seller who may easily be taken advantage of.\textsuperscript{15} Also, life insurers have resisted the life settlement industry. In addition to wishing to avoid taint by association, life insurers have an immediate pecuniary interest. Actuaries build assumptions about lapse and surrender rates into their premium pricing models. Life settlements reduce lapse and surrender rates and thus cut into life insurer income. According to Duhigg (2006), nearly 20 million life insurance policyholders stopped paying premiums on $1.1 trillion in policy face value in 2005. If all of these policies had been sold on the secondary market, insurers ultimately could have faced up to $1.1 trillion in additional claims payments, not counting the expected premium revenue that could have come from the lapsed policies.

The general intent of both the NAIC and NCOIL model acts appears to be regulating the transfer of ownership of life insurance for purposes of settling policies for the terminally ill and those who might obtain more from a life settlement than they otherwise would from a policy surrender. Texas and Florida state insurance regulations go further, requiring life expectancy underwriters to register with state authorities. The Texas and Florida regulations attempt to control some of the more troublesome aspects of recently disputed life settlement transactions, notably the estimates of life expectancy of insured lives in the settlement transactions.

Of special note is a separate piece of model legislation, the Life Insurance Consumer Disclosure Model Act introduced by NCOIL in 2010, requiring disclosure to clients that policyholders have an alternative to surrendering or lapsing a policy. This proposed legislation, if enacted in all jurisdictions, most likely will accelerate use of life settlement transactions.\textsuperscript{16}

The NAIC and NCOIL model life settlement acts attempt to prevent STOLI transactions through a variety of requirements, including a waiting period prior to transfer of ownership. The NAIC life settlement act requires a five-year waiting period, with certain exceptions for terminally ill policyholders, while the NCOIL life settlement act requires a two-year waiting period. The NCOIL act specifically

\textsuperscript{15} See \textit{The Insurance Forum} (ed. by Joseph Belth) for documentation of numerous instances of fraud and abuse—e.g., in the category “Secondary Market Transactions” at www.theinsuranceforum.com.

\textsuperscript{16} Life insurers also may increase their life settlement offerings to compete with the secondary life settlement market. According to the ACLI, “accelerated death benefits” are generally available as part of a policy or as a rider; usually, these benefits are paid for insureds with less than two years to live.

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defines STOLI and prohibits it as a “fraudulent life settlement act,” whereas the NAIC act appears to make STOLI transactions merely more difficult to complete than before passage of the act. 17,18

A recent ruling in Delaware appears to be unfriendly to investor-initiated life insurance transactions. In September 2011, the Delaware Supreme Court ruled that insurers may “challenge the legitimacy of a policy that changed hands at any point, even after the standard two-year window for contesting policy payouts has expired” (Scism, 2011). In Delaware, investors now face uncertainty about whether they are entitled to death benefits. If the ruling were to spread, the legal risk of participating in these transactions—when added to the mortality risks—may slow or end the life settlement securitization market as we know it.

Conflicting court rulings in multiple jurisdictions appear to cast some doubt on the legal reliability of STOLI transactions. In New York and California, STOLI appears to be legal, subject to caveats, for older policies. In November 2010, the New York State Court of Appeals upheld the right of a life insurance applicant to secure a policy for prompt sale into the secondary market. In Kramer v. Phoenix Life Insurance Company, the insurer and heirs to the deceased (Kramer) challenged the transfer of ownership in a series of life insurance purchases. The court ruled that such a transaction, regardless of intent or timing of the ownership transfer, is permissible. In the words of the majority:

“‘Does New York Insurance Law §§ 3205 (b) (1) and (b) (2) prohibit an insured from procuring a policy on his own life and immediately transferring the policy to a person without an insurable interest in the insured’s life, if the insured did not ever intend to provide insurance protection for a person with an insurable interest in the insured’s life?’

“We now answer in the negative and hold that New York law permits a person to procure an insurance policy on his or her own life and immediately transfer it to one without an insurable interest in that life, even where the policy was obtained for just such a purpose.”

A similar court ruling applies in California. However, both New York and California have adopted new laws that bar STOLI. But the courts of each state have interpreted the new laws to apply only to policies issued after the new laws were enacted.19

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17. According to the Life Insurers Fact Book (2012), the number of life insurance claims disputes nearly doubled from 2001 to 2011. Several industry observers have attributed at least some of those additional disputes to challenges by insurers against life settlement transactions and STOLI.

18. For a detailed direct comparison of the NAIC and NCOIL model acts, see SEC (2010), Appendix E (as provided by the National Association of Insurance Commissioners).

19. See Byrnes and Bloink (2011) for New York, and Henderson and Tam (2011) for California. The STOLI prohibition in section 7815 of the New York Insurance Law was effective in May 2010. The California Act (CA Stats. 2009, ch. 343, §1(d)-(e)) was effective as of July 1, 2010.
In June 2013, Texas enacted a law that requires Medicaid recipients to be informed of the opportunity to sell their life insurance policy in a life settlement transaction to fund long-term care expenses, while maintaining Medicaid eligibility. Hersch (2013) points out that, prior to passage of the law, Medicaid applicants with life insurance were required to surrender their policies. Other states are considering similar legislation.

These changes carry implications for both life settlement volume and insurer profitability. Moody’s commented on the new Texas law, noting that passage of the law would hurt the profitability of life insurers: “With similar bills in seven other states pending, an expansion of life settlements on a large scale would produce fewer lapses and more covered deaths than originally priced for…” See Hersch (2013).

The Structure of Life Settlement Investments

In a basic life settlement transaction, the policyholder names an investor as beneficiary of his/her policy in return for a cash payment from the investor through the settlement broker. The policyholder unconditionally assigns his/her contract rights/responsibilities to the investor, receiving in turn a negotiated sum of money. Contract rights are considered legal property that can be transferred. It is essential that the life settlement assignment transfer the insured’s contract rights cleanly and absolutely. A collateral assignment, in which the transfer could be reversed upon satisfaction of certain conditions, would deter investors. So would the existence of irrevocable beneficiaries unwilling to surrender their priority rights to the investors. Once assigned, the investors become responsible for the performance of the contract, meaning investors then pay the annual premium until death of the policyholder. The investors then receive the proceeds of the policy upon death of the insured. Typically, the settlement contract will call for periodic reports on the health of the insured. Investors also must arrange for notification upon death of the insured.

More usually, the policyholder will assign a holding entity as beneficiary. The settlement broker can then fractionate the policy and sell viatical shares. This grows the market by making viatical interests more attractive to investors of moderate means. It is also attractive to wealthy investors, who can more easily diversify their portfolio among multiple lives and reduce their overall risk.20 In this

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20. There is anecdotal evidence of an active market for stop loss insurance to protect individual investor life settlements. In such a transaction, investors who are concerned about lengthy time-to-death exposures can purchase coverage against the possibility that the insured lives beyond two years.

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case, the policy is held in trust. The trust pays the annual premiums from funds deposited at creation, or following annual cash calls upon investors. The trust distributes ultimate proceeds in proportion to shares owned. Taxes are the responsibilities of investors.

Some settlement brokers have assumed investment banker roles. For example, a company may buy policies directly from policyholders on its own account. The company may then bundle policies into a private placement fund, which it may market to wealthy investors outside the constraints of the Securities and Exchange Act of 1934. The company also may create a fund and raise capital for this purpose before actually acquiring any settlements. In addition, the company can bundle policies into tranches based upon the gender, age and health of the policyholders and market the product as viatical-backed-bonds, much as mortgages can be bundled and marketed as mortgage-backed securities. The company need not be constrained to acquiring actual life insurance policies. By using derivatives and swaps, the company can create synthetic policies without even the knowledge of the people involved.

The possible development of a market for synthetic policies is worth some further discussion. Although we lack personal knowledge of synthetics and doubt that a substantial market for synthetics currently exists, we foresee the possibility of its growth if the legal and regulatory restrictions on traditional life settlements become too onerous. Brokers and investors currently active in life settlements may seek potentially less restrictive venues for their activities. There are many forms such markets could take. For example, a company could sell puts to anyone on the life of anyone else. The put would be similar to a single-premium term life insurance policy and therefore a candidate for a “life settlement” transaction, given the right conditions—such as a turn for the worse in the health of the insured. In this scenario, if there is a lack of underwriting, both at the origination of the put and at its sale in a “life settlement” transaction, then the issuing company may wish to hedge its risk by purchasing a matching put from investors. Because of the enhanced risk from the absence of underwriting, investors would probably demand much higher returns than in usual life settlements. A purely speculative market could develop for puts on the lives of celebrities and others in the public spotlight, for whom maintenance of privacy of medical conditions is much more problematic.

If such a market became widespread, how would stakeholders react? Stakeholders can be expected to adopt positions that favor their own interests. The legal issues would revolve around the question of whether the issuing company’s puts are insurance, securities or something else—and who, if anyone, is authorized to regulate them. A contract need not be explicitly labeled “insurance” or “security” in order to be construed as such and fall under some state or federal

21. The sale of life insurance on unsuspecting insureds does occur in specific situations. For example, with company-owned life insurance (COLI) transactions, a business purchases life insurance policies on key employees with the company as beneficiary. The employees may not be informed that they have been insured. In 1993, Winn-Dixie Corporation bought life policies on 36,000 of its employees without their knowledge or consent (Myers, 2008).
regulatory regime. State insurance regulators would probably argue that the issuing company is engaged in the sale of unregistered insurance products. Life insurers would probably argue further that the put buyers (“policyholders”) lack an insurable interest and therefore the put (the “policy”) is voidable as gambling, contrary to the public interest. The IRS would probably argue that the put is an option—a security—and is therefore taxable in the same way other put options are taxable and does not qualify for the tax-favored treatment accorded to life insurance. The put buyer would probably argue that the put is life insurance, and therefore she should receive the proceeds tax-free. The person covered by the life insurance policy may be upset that others are “betting” on his life without his knowledge. The issuing company’s stance is less predictable. If it concedes either that the put is insurance or a security, it opens itself to regulation in either case. Most likely it would try to argue a third option in order to avoid any regulation. If the issuing company’s puts were to be classified as insurance and then further found to be gambling on account of absence of an insurable interest, its operations could be prohibited as contrary to public policy. It is likely that the company’s defense would be structured to avoid the latter outcome at all costs. It is beyond the scope of this article to explore whether the scenario just outlined would be good or bad for society. Certainly, the macabre aspects of the scenario are readily imaginable. Rather, we merely point out that the life settlement industry may have alternative avenues for continuing or expanding its activities.

22. Both FASB #113 (for generally accepted accounting practices—GAAP) and SSAP #62 (for statutory accounting) provide essentially the same definition of insurance: “Insurance provides indemnification against loss or liability from specified events and circumstances that may occur or be discovered during a specified period” (FASB #113, 1992). With some exceptions, in common law the element of “insurable interest” must also be present. For life insurance, this means that the policyholder or beneficiary would suffer a direct loss if the insured were to die at the inception of coverage (but not necessarily later). Were the element of insurable interest not required, then gambling schemes could be constructed to have the form, although not the substance, of insurance and thereby become legally enforceable. Also, in absence of an insurable interest, some persons might be tempted to murder strangers on whom they had taken out life policies.

23. The McCarran-Ferguson Act of 1945 explicitly assigns regulation of insurance to the states. All states have adopted statutes to regulate the sale of insurance products within their borders to protect the public interest.

24. The Securities Exchange Act of 1933, as amended, defines “security” broadly and exhaustively to mean “any note, stock … any put, call, straddle, option or privilege on any security …” (Section 2(a)(1)). Although puts on securities provide indemnification against loss and the element of insurable interest may be present, puts are not regulated as insurance products. Moreover, Section 3(a)(8) of the Securities Exchange Act of 1933, as amended, explicitly exempts from the Act’s purview any insurance products that are regulated by the states.

25. The primacy of state regulation of insurance under McCarran-Ferguson has been noted previously. The Securities Exchange Act of 1933 created the Securities Exchange Commission (SEC) and assigned it federal authority to regulate sale and trading of securities.

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Issues in Life Settlement Transactions

Taxation of Life Settlements

One of the motivations for this article was our curiosity about the way alternative structures for the transfer of policyholder interest might affect the tax treatment of a viatical. For illustration, let us return to the basic life settlement, with one investor.

Life insurance proceeds enjoy a tax subsidy under the Internal Revenue Code (IRC). The key provision is found in Section 101 of the IRC:

Sec. 101. Certain death benefits
(a) Proceeds of life insurance contracts payable by reason of death
(1) General rule

Except as otherwise provided in paragraph (2), subsection (d), subsection (f), and subsection (j) gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.

This provision says that life insurance proceeds are not taxable to the recipient when paid because the insured has died. Beneficiaries of this largesse are not limited to family members under this provision. The provision would seem to create an opportunity for creative structuring of life settlements so that viatical investors could escape taxation. However, the IRC section immediately following anticipates that possibility and constructs a hurdle:

(2) Transfer for valuable consideration
In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee.

This provision says that if the policyholder receives anything of value in return for transferring his/her policy, then the transferee’s ultimate profit (insurance proceeds received, less acquisition and holding costs) is taxable. But there are exceptions to this exception:

… The preceding sentence shall not apply in the case of such a transfer -
(A) if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor, or

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(B) if such transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

This provision recognizes that a business has a legitimate interest in insuring the life of a key employee and that the tax-free treatment of proceeds should not be affected by the form of the transfer. For example, an employee may transfer a pre-existing policy to the business or the business may transfer its policy on the employee’s life to the employee upon termination. If some consideration were given in these transactions, the tax-free status of proceeds would then be undermined, were it not for this provision. A creative application of Section 101(a)(2)(B) would be to form a partnership with a policyholder, then transfer the policy to the partnership for consideration, and ultimately claim tax-free status of the proceeds. To our knowledge, no one has tested this approach. Possibly, the IRS would claim the partnership is a “sham transaction” and recharacterize the proceeds to reflect its view of economic reality—an authority that the law explicitly accords to the IRS. We do not see any ways, other than creative but practically dubious ways like the partnership idea, to structure life settlements so that proceeds would be tax-free to the investor. Moreover, in a report to Congress on ChOLIs (charity-originated life insurance, a subset of STOLI), the Treasury Department (2010) recommended amending the transfer-for-value section 101(a)(2) quoted above, to close the door on any possibility that investors in transfers of life insurance contracts of any type might benefit from the non-taxation of death benefits.

So if life settlement proceeds are taxable, how can the tax be minimized? The tax treatment of investor gains on life settlements is in flux. Prior to 2009, the position of the IRS was that all investor gains on life settlements were taxable as ordinary income. Wealthy investors paid tax on their viatical gains at marginal rates up to 35%. For detailed discussion of pre-2009 tax treatment, see Evans, et al (2009). However, in 2009, the IRS issued Rev. Ruling 2009-13 and Rev. Ruling 2009-14, which consider the taxation of gains for both the seller and the buyer of life insurance contracts.

Revenue Ruling 2009-13 considers the taxation of income to the original seller of life insurance contracts in a life settlement transaction. In a term life insurance contract, generally the seller of an insurance contract will realize long-term capital gains, with the seller’s cost basis defined as gross premiums paid less the cost of insurance protection. In a whole life insurance policy sale, if the cost basis is less than cash surrender value, then a portion of gain up to the difference between cash surrender value and cost basis is taxable as ordinary income. Since most policyholders will not sell their policies if they can get more from a policy

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surrender, there is an income component beyond the surrender value (sale proceeds less surrender value). Thus, the usual situation in both term life and whole life sales is that at least a portion of the sale proceeds is treated as a capital gain; if held longer than one year, then the gains are long-term.

Revenue Ruling 2009-14 focuses on investor taxation. This ruling grants capital gain status to investor gains from the resale of purchased life insurance contracts. The ruling also holds that the net proceeds (death benefit less all costs of acquiring and holding the policy) of death benefits from a term life contract held until the insured’s death receive ordinary income status. However, uncertainties remain. Rev. Ruling 2009-14 specifically deals with investor gain from the resale of life settlements; it does not explicitly characterize investor gains when the investor holds the policy until maturity. In addition, these rulings do not address investor taxation on the sale or resale of cash value life insurance. Since cash value life insurance is a significant portion of the life insurance settlement market, the tax status of many life settlements remains unsettled. The position of FINRA is that universal variable life contracts are securities—and therefore presumably subject to capital gain tax rates.

Another attempt to avoid taxation of viatical gains as ordinary income could be to create a company that would pay dividends on viatical earnings. Under the IRC, qualified dividends receive favorable tax treatment with a maximum tax rate of 20%. However, if structured to qualify for the favorable rate, it is likely that the company would be required to pay tax on its earnings, thus incurring double taxation of the viatical proceeds—once at company level and once at investor level. If structured as a pass-through entity, the company would pay no tax, but the investors would pay tax on the proceeds, which would be characterized the same way that they would have been for the company.

It also appears possible to reduce taxation of life settlement investor income by creating a vehicle focused on the purchase and resale of policies—rather than holding them for the payment of death benefits—since profits from resale are treated as capital gains, unlike the income produced by waiting for the insured to die. For example, one could form three limited partnerships with the purpose of allocating the income from life settlements; the first two could buy then resell a life insurance policy to characterize the income as capital gains. A third could hold more mature policies until the insured’s death and incur gain taxed as ordinary income. Tax-favored accounts (such as IRAs) could hold interests in the income form, whereas the first two could be held by a clientele desiring capital gains income.

29. For analysis and interpretation of these rulings, see Martinez and Bloomfield (2009). Also, see Insurance Studies Institute (2009).

30. Another note is that a Revenue Ruling differs from the Internal Revenue Code. The IRC is the law as Congress wrote it. A Revenue Ruling is the IRS interpretation of the IRC. Revenue Rulings are not law; they can be challenged in court and can be administratively revised.

31. Tax rates for 2013 have been established, but rates beyond 2013 are uncertain, pending the outcome of legislation.
Conclusion

The recent history of life settlements presents considerable issues for investors and regulators. The evolution of the life settlement market depends on resolution of multiple uncertainties for investors—recent court and tax rulings serve to resolve, or at least make clearer, some of those uncertainties. This article suggests that some aggressive tax solutions might influence the investor marketplace. As the market matures and taxation questions are resolved, offers to willing sellers of life insurance contracts are likely to rise as the result of increased competition, enhancing wealth for policyholders.

Furthermore, life insurers likely will decide that the best way to capture value lost to the life settlement industry is to offer their own solutions. These solutions include raising surrender values for qualifying policyholders, entering the life settlement market as active buyers of policies, and more careful vetting of sales likely to end up as STOLIs.

One possible solution would be to include a contractual provision that gives the life insurer the right of first refusal to match any viable life settlement offer. In so doing, the life insurer would easily recapture most of the value lost to intermediaries in life settlement transactions. The right of first refusal provision, if approved by regulators, potentially would cripple the life settlement business, since all of the incentive to generate activity would be ceded to life insurers and policyholders.

An important legislative development is this vein is the inclusion in the Pension Protection Act of 2006 (P.L. 109-280) of provisions that foster the spread of hybrid annuity and life insurance policies combined with long-term care insurance. For hybrid policies issued after January 1, 2010, tax-free cash withdrawals may be made in order to pay for long-term care or premiums.\(^{32}\) We expect policies that qualify under this legislation to be less subject to sale in the settlement market, as they provide internal means for policyholders to fund personal needs. Future transactions are likely to become more transparent due to disclosure requirements. The end result is an arguably better allocation of capital across economic actors, an outcome evidenced in many areas of the insurance industry over the past two decades.

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32. (Ibid., Title VIII, Subtitle D, Section 844).
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