

Robin & Peter on LIFE SETTLEMENTS



September 27, 2011

"Paid-Up" Life Settlements: What You Need To Know

There are times an elderly insured may want to keep, or can only afford to keep, some of the coverage on a policy that they own. Splitting off a portion of the unneeded death benefit could be a life settlement opportunity, but insurance policies usually do not contractually permit dividing up a policy for such purposes. Generally, the policy owner's only option is to reduce the face amount and then the remaining death benefit disappears without value.

So-called "paid-up" life settlement programs can offer a reasonable alternative for an insured that still wants some, but not all, of the coverage that is provided by a policy. **These programs offer the policy owner a reduced, retained death benefit for no continuing premiums in exchange for their life insurance policy.**

The flexibility of these programs can offer policy owners the opportunity to negotiate an arrangement which best suits their needs. Sometimes the retained death benefit is the only compensation for the policy, while other times it may be combined with a cash payment. The death benefit itself can be structured to vary depending on when death occurs. All in all a "paid-up" life settlement can be an attractive alternative to a pure life settlement or to lowering the face amount of an existing policy.

Before entering into one of these programs, however, there are some important considerations that a policy owner should evaluate. First, **although many of these programs use the words "paid-up" in their description, they do not offer a paid-up life insurance policy in the traditional sense.** Traditionally, a paid-up life insurance policy is one issued by an insurance company that requires no additional premiums and will pay a specified face amount for some period of time.

Many of these programs offer, instead, a contractual promise to pay a death benefit in the future which is like a paid-up insurance policy except that the promise is not made by an insurance company, but rather by the purchaser of the policy. So the seller's death benefit, due at some future time, rests on the continued financial viability of the purchaser, which typically is not an insurance company and not subject to the considerable regulatory safeguards that have been enacted to ensure the financial strength of insurance companies.

Alternatively, sometimes an irrevocable beneficiary arrangement is offered, so that the death benefit would be paid by an insurance company. This, however, offers only a modicum of safety as the seller is still dependent on the buyer to pay the premiums. If the buyer gets into financial difficulty and is unable to pay the premiums, the policy could lapse and no death benefit would be payable by the insurance company.

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 arrangements 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.

A deal for an actual paid-up life insurance policy would likely qualify as a tax-free 1035 exchange. Other types of arrangements, however, including a 1035 exchange with some additional cash paid to the seller, could result in income taxation immediately, during the life of the seller, and/or upon death. Due to these uncertainties and the possibility of significant tax consequences, **sellers should seek the advice of their own tax advisors when contemplating accepting one of these offers.**

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 and uncertainties of these transactions, however, require that they be evaluated carefully prior to making a decision. **Our expertise in both life insurance and life settlements can help you and your clients make the right choice.**

Remember, when one of your clients or prospects is contemplating reducing or eliminating some or all of their life insurance coverage, it always pays to check with us first to be sure that they are not leaving any value on the table.

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