By Stephen M. Margolin and
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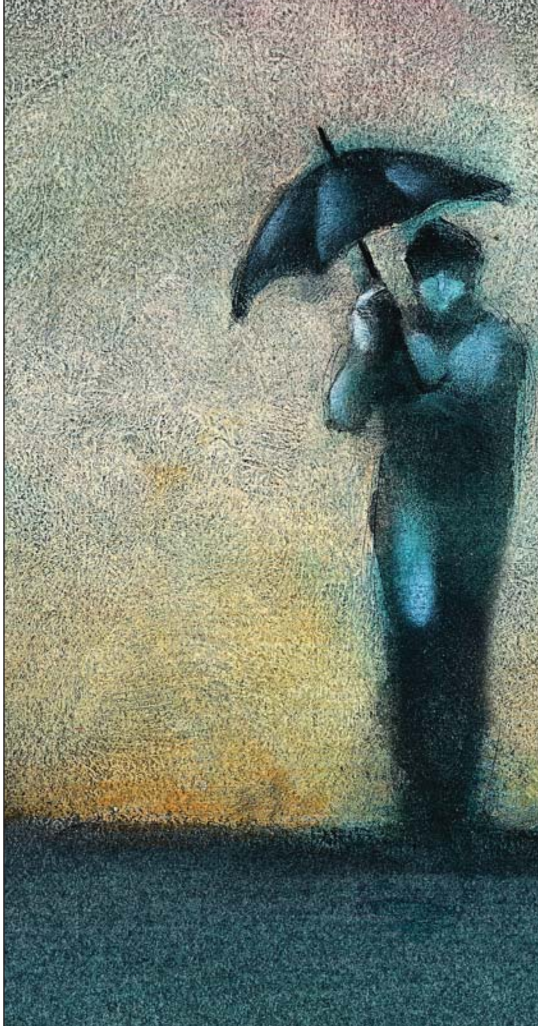
Stranger-Owned Life Insurance: The Risks and Rewards

Perhaps you've read about it or seen it on TV, or perhaps a client has approached you about it. The plan works this way: an elderly person lets investors buy insurance on his life in return for a hefty cash payment. At the end of two years, he can reimburse the investors the premiums they paid – plus interest – and keep the coverage, or he can drop it with no obligation. And he keeps the up-front cash either way.

It's called stranger-owned life insurance ("SOLI"), and it's a controversial but increasingly popular financial device. Do the risks outweigh the rewards? James C. Shanley is skeptical, Stephen M. Margolin and Valerie J. Freireich more sanguine. Here are two sides of the SOLI story.



The Rewards: A Fictional Case Study

Rather than resisting stranger-owned life insurance, insurers and other critics should accept and try to profit from it, these authors argue. They use a case study to describe how it can work to the benefit of all parties.

Isaac Insured was resting comfortably on the couch when he got a call from Aaron Agent. Ike is a customer of Aaron's. He is also a healthy, married 78-year-old who has no life insurance despite his ample net worth.

Aaron asks Ike whether he might be interested in acquiring life insurance at a face amount of $4 million. The policy owner would not be Ike but an irrevocable life insurance trust ("ILIT") – an arrangement that sounds strange but could have real advantages for Ike.

Curious but skeptical, Ike asks Aaron to explain. "Why would I want to buy a policy through an ILIT? And what will the premium be?"

Aaron explains that an ILIT is a special purpose trust. The insured is the creator – or "grantor" or "settlor." The trust is established to own life insurance on the grantor's life for the benefit of his family members.

Aaron says that there are benefits to having an ILIT own the policies rather than Ike owning it himself – benefits he doesn't fully understand. He suggests Ike discuss this with his attorney.

As for the annual premium, Aaron tells Ike that it will be $100,000 for this $4 million death benefit policy.[1] A lot of money, Aaron concedes, but it can be financed.

1. Note that the annual premium is $100,000 for a $4,000,000 death benefit policy. Thus, the premiums are 2 1/2% of the death benefit, which enhances its interest to a life settlement company, since 2 1/2% is considered a modest premium.

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Aaron explains that once a life insurance policy is acquired, it can be kept until maturity and that, provided the premiums are paid, at Ike's death the policy benefits would be paid to the ILIT, which would distribute its proceeds pursuant to the terms of the ILIT – to beneficiaries designated by Ike in the ILIT document, thus, presumably, to Ike's wife, Sylvia, and their children and grandchildren.

And – here's where things get interesting, Aaron said – there are other options, too, that could make this a good deal for Ike. One is selling the policy to a life settlement company after a two-year contestability period.[2]

Aaron explains that a new market for life insurance policies has opened up, and selling the policy can provide more cash to the insured than the cash surrender value. In addition, this is cash to the ILIT (the policy owner), and can be used by Ike's wife and children (and indirectly himself) during his lifetime.

Ike, still interested, nonetheless wonders aloud whether that doesn't go against the very purpose of life insurance – to provide assistance to his survivors. Isn't that why, Ike asks (remembering a conversation with his estate planning attorney), in most states a life insurance policy is not subject to claims of creditors?[3]

Aaron agrees that life insurance is protected, and lets Ike know that an ILIT itself will provide further asset protection to Ike, as the grantor, and asset protection to the ILIT beneficiaries.[4] But, says Aaron, lives have an insurance value. The face amount of life insurance Ike can obtain generally cannot exceed his net worth. Over that amount, insurance is considered gambling on one's life, which is against public policy.[5]

Still, the life insurance value of an insured's life is, in some sense, his (or her) property: he can pass it on to the next generation by paying the premiums and letting the policy "mature" upon his death, or he can use it as a current asset by taking advantage of his insurability through cash surrender value or by sale of the policy.

In any case, Aaron tells Ike, the choice does not have to be made immediately. In fact, Aaron says, it should not be made immediately because an intent to sell the policy before or at the time the policy is acquired could make it voidable by the insurance company issuing it for lack of an insurable interest.

Ike remains intrigued. He likes the idea that his life has a value in and of itself, a value that relates to how hard he has worked and the assets he has built up.

Potential sale to a life settlement company

A few weeks later, Aaron gets a call from Ike. "I did some checking on this," Ike says. "Some drug-lord in Bogota could buy my policy and then have me knocked off so he doesn't have to pay more in premiums. No thank you!"

Aaron chuckles. "Only on TV," he says. "Most life settlement companies buy a large number of policies, package them, and sell them to institutional buyers, which are the biggest banks and brokerages."[6]

The policies are attractive to these institutions, because they are noncorrelative with other investments, such as stocks, bonds and real estate. He explains that for the life settlement companies to profit they must hold a number of policies, because gain is based on an actuarially broad cross section of insureds.

Further, since Ike is 78, because of the two-year incontestability provision, he would be 80 or more at the time of any potential sale. This means, based upon the experience in the secondary marketplace, a life settlement company could pay, for example, approximately 14 percent of the face value, or $560,000 to the policyholder ($4,000,000 x 14% = $560,000), resulting in a possible gain that would go directly to the ILIT.

"Gain?" You mean taxable gain?" Ike asks.

"For the answer to that, you really should talk to your accountant or lawyer," Aaron says.

Taxability of proceeds upon death of insured

Ike calls his attorney, Larry Lawyer, while Aaron waits. "Tell me about irrevocable life insurance trusts," Ike asks.

Larry informs him that in the event of Ike's death, the policy proceeds are income tax free to the ILIT, under Internal Revenue Code Section 101(a). Since the policy is in an irrevocable trust,[7] and excluding any incidents of ownership[8] held by Ike, as the insured, the policy proceeds at Ike's death will not be subject to federal estate tax.

Further, if the ILIT is drawn properly – and Larry tells Ike that Larry has prepared many ILITs – there is no estate, gift, or generation-skipping tax ("GST") to Ike's descendants.[9] Also, there is strong asset protection for the beneficiaries throughout the existence of the trust. A trust may provide that it will not terminate prior to the expiration of the statute of limitations of the state that governs its construction and administration. This is at least 90 years in many states[10] and in perpetuity under Illinois law.[11]

Ike could pay the policy premiums personally by contributing up to $100,000 per year to the ILIT, Larry tells him, without reducing his applicable exclusion of $3.5 million (in the event of death in 2009). This is because of an annual exclusion amount of $13,000 (on and after January 1, 2009) for gifts of Ike

2. Life insurance policies typically have a two-year contestability period. That is, they are incontestable two years after the policy issue date. So, theoretically the carrier cannot challenge a claim or avoid liability thereafter, except perhaps for fraud. Many states require this provision. California Insurance Code §10113.5; Florida Statute §627.455.

3. See Gideon Rothschild and Daniel S. Rubin, *Credit Protection for Life Insurance and Annuities* at http://mosessinger.com/articles/files/creditprotec.htm.

4. The ILIT itself offers asset protection to the grantor and ILIT beneficiaries by having a strong spendthrift clause. However, this is subject to the fraudulent conveyance laws of each state.

5. Holman W. Jenkins, *Life Insurers Face the Future, Grudgingly*, Wall Street Journal, August 9, 2006.

6. James C. Magner, *What is Life Insurance, The Evolution of Financial Products*, Page 26, Trusts and Estates, April 2008.

7. A trust is considered revocable for purposes of the gross estate tax if the decedent made a transfer to it and, alone or with any other person, has the power "to alter, amend, or revoke" the trust, or where "decedent relinquished any such power during the three year period ending on the date of the decedent's death." IRS Code section 2038(a)(1). Thus, to render the trust irrevocable those powers must be specifically renounced in the trust.

8. Regardless if there is an irrevocable trust, if the decedent possessed at his death any "incidents of ownership" of a life insurance policy, that policy is includible in his gross estate, under IRS Code section 2042(2).

9. Upon filing of a Form 709 Gift Tax Return, pursuant to IRS Code section 2632(c), the GST exemption is allocated to the property transferred, which are the premiums transferred to the trust. Since the premiums are exempt, the proceeds are also exempt from GST, which means that the proceeds could descend transfer tax free from generation to generation, if the ILIT provisions allow for that.

10. The statutes of limitation of many states provide that after the statute has expired, trust property must vest in the remaining beneficiaries. This is done by a formula that typically reads:

> "When the interest is created, it is certain to vest or terminate no later than 21 years after the death of an individual then alive," or
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> "The interest either vests or terminates within 90 years after its creation."
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> California Probate Code §21205.
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> In Florida, the Statutory Rule Against Perpetuities is 360 years. The Statutory Rule Against Perpetuities §689.225, Title XL Florida Statutes.

11. The rule against perpetuities does not apply under Illinois law if the trust so states, and the power of the trustee to sell property is not limited by the trust instrument. 765 ILCS 305/3.

and Sylvia to the ILIT, times the number of donee beneficiaries.[12] The total annual exclusion equals $104,000, since there are four descendant beneficiaries of the ILIT (4 x $13,000 x 2 = 104,000).[13]

Ike asks, "What if the ILIT trustees decide to sell the policy? How is gain taxed?"

Taxability of proceeds upon sale of policy

Gain on the sale of property must be recognized,[14] Larry Lawyer tells Ike and Aaron. He explains that the difference between the cash surrender value and the investment in the contract constitutes ordinary income.

There is a practical reason why insurance companies resist this secondary market. When a policy is sold to an individual, statistics show, most purchasers eventually let their policies lapse.

Larry says that there is a difference of opinion between the Internal Revenue Service ("IRS") and most tax practitioners regarding the total investment in the contract and capital gain treatment.

The IRS position, set forth May 26, 2009, in Revenue Ruling 2009-13,[15] is that the recognized gain is the difference between the amount realized (the selling price) and the selling owner's adjusted basis. The adjusted basis is the seller's investment in the contract.

Most practitioners consider that this consists of the premiums paid. However, Revenue Ruling 2009-13 states that the cost of pure insurance must be subtracted from basis. This increases the seller's taxable gain. Further, that Revenue Ruling states that to the extent of the difference between cash surrender value and premiums paid, the gain is treated as ordinary income.

The IRS position has been thoughtfully criticized.[16]

Larry notes, "When a policy is sold within a few years of issuance, there is very little – or no – cash surrender value.[17] So, the difference between the adjusted basis and the proceeds received is long-term capital gain."

Premium payments

After consulting further with his attorney and his family, Ike decides to form and fund the ILIT to buy the $4 million universal life policy. Six months after the policy is acquired and paid for by the ILIT, the trustees contact a premium finance company.

Premium finance company

Freddy Financial's business is loaning funds to finance life insurance premium payments. Freddy lets the ILIT trustees know that there are a broad range of possible terms. Freddy's offer to the ILIT is as follows: (a) there will be a "structuring fee" equal to 1.25 percent of the face amount of the policy, (b) the interest rate will be 9 percent per annum, (c) the maturity date of the loan will be 30 months from the date the policy was issued, (d) there will be no payments due (neither interest nor principal) until the loan term ends, (e) the policy must be pledged as collateral, (f) the policy owner (the ILIT) will retain 100 percent of the net economic value in the policy (i.e. will receive policy proceeds less the principal amount of the loan, accrued interest and loan expenses), (g) only the ILIT has personal liability for repayment of the loan, and (h) an affiliate of Freddy's finance company may participate in any sales commission, if the policy is sold.

Freddy Financial works out the numbers for Ike, recognizing that the premiums for six months have been paid. Thus, the initial amount loaned would be the 1.25 percent structuring fee of $50,000 (1.25% x $4,000,000), plus the $50,000 premium for half a year. After the end of the first year, the policy owner owes $104,500 ($100,000 + $4,500 ½ year interest). Adding the next $100,000 premium in the beginning of the second year increases the loan to $204,500. Nine percent interest thereon equals $18,405, or a total owed at the end of the second year of $222,905 ($204,500 + $18,405).

After 24 months, but not later than 30 months from the policy issue date, when the loan will come due, the policy owner (the ILIT) will have a choice of paying off the debt and retaining the policy, allowing the policy to lapse, or selling it.

After consulting with Ike, the ILIT trustees diligently consider all options.[18] Exercising their fiduciary duties to explore the best approach for the trust beneficiaries, the ILIT trustees ask Aaron Agent to determine the policy value on the secondary market.

The life settlement company

Aaron contacts Barry, a broker[19] who has contacts with providers representing life settlement companies. Life settlement companies are ultimately responsible for coming up with the funds to buy policies.

Barry obtains a commission on the sale, which often amounts to between one and two percent of the policy face amount. An affiliate of the premium finance company and the producer may also participate in the commission.

Types of life insurance policies

Life settlement companies generally only buy permanent policies. These include whole life, universal life, or convertible term policies (converting to a

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12. IRS Code section 2503(b).

13. See IRS Code section 2513 on gift splitting. Also, M. Howard Zaritsky and F. Stephen Leimberg, *Tax Planning with Life Insurance*, section 5.03(3)(g).

14. Letter Ruling 200504001, issued 10/12/04 states:

> Under section 1001(a), gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain. Section 1001(b) provides that the amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. Section 1001(c) provides that except as otherwise provided in subtitle A of the Code, the entire amount of the gain realized under section 1001(b) must be recognized.

15. Revenue Ruling 2009-13, 2009-21 IRB 1029 (5/26/09), Situation 1 on surrender of a policy, and Situation 2 on sale of cash value policy.

16. LISI Estate Planning Newsletter 1459, available at Leimberg Information Services, Inc., http://www.leimbergservices.com/Article_detail.cfm?article_id=8387&criteria=

17. If the policy is sold within the first two or three years, there is little or no cash surrender value, because that has been expended on commissions. Donald O. Jansen, *Split Dollar Insurance and Premium Financing Planning*, 33rd Annual Notre Dame Tax and Estate Planning Institute 2-56.

18. The trustee of the ILIT which owns the policy, must make a careful decision on retaining, lapsing, or selling the policy. If the insured's health has markedly declined, it may be prudent for the trustee to secure funds from the insured or other family members to pay off the debt to the premium finance company. Thereafter, upon the demise of the insured, the proceeds, which are income tax and estate tax free in the ILIT, reside in the trust for the benefit of the trust beneficiaries.

19. A broker is an individual or company who works on commissions and is state licensed to sell life insurance policies to life settlement companies.

permanent policy).[20]

Whole life policies usually have a level premium over the life of an insured. Universal life policies are often preferred because they frequently have a lower premium than whole life. However, universal life policies must be diligently watched to make certain that the amount paid in on the policy is sufficient to prevent it from lapsing.

The life settlement offer

A life settlement company, after considerable due diligence, makes an offer of 13.75 percent of face, or $550,000 ($4 million x 13.75%) to the ILIT. This figure is after a (1 percent of face amount) $50,000 commission split among the broker, et al. The gross of $550,000 will be paid to the ILIT, less the $222,905 finance costs. The sum of $327,095 ($550,000 - $222,905) constitutes the pretax proceeds that would remain with the ILIT policy owner.

The ILIT trustees confer with Ike, Sylvia, and other family members. Ike is 80 and Ike's health has rapidly deteriorated during the prior year. The family is alarmed at his medical prognosis. He wants Sylvia to be comfortable if something should happen to him; the policy proceeds of $4 million look better than $327,095 in cash.

Ike offers to pay the premiums that are coming due and to provide sufficient funds to pay off the loan. The ILIT trustees decide against selling the policy. Thereupon the policy remains the property of the ILIT; the ILIT trustees pay off the loan and continue to pay the policy premiums.

Thus, notwithstanding the twinkle in Ike's eyes during discussions of sale on the secondary market when the policy was first purchased, the policy is not sold. Importantly, the policy might never have been purchased if Ike had not seen that he had an opportunity to sell.

Resistance from insurance companies

And thus we end our tale. Not everyone considers it a happy one.

Many insurance companies and their reinsurers are troubled by (and begrudge)[21] the secondary market for life insurance policies that makes stories like Ike's possible.[22] Some commentators fuel this antagonism by exaggerated safety concerns, warning prospective insureds that the prospective policy could, ominously, be a "SOLI policy."[23]

Some complain that it is immoral for a bank or brokerage (or institutional affiliate thereof) to own policies on an unrelated insured. Ignoring "key man" life insurance and charitable use of life insurance, these commentators posit that only a family member should ever own an insured's policy.

But there is a practical reason why insurance companies and reinsurers resist this secondary market. When a policy is sold to an individual, statistics show, more than 80 percent of purchasers eventually let their policies lapse.[24] Thus, the insurers only have "death claims" for 20 percent of the policies they sell. Yet when a life insurance settlement company buys a policy, it will hold the policy until maturity, which means there are essentially 100 percent death claims made for policies owned by a life settlement company.

Rapprochement between insurance companies and life settlement companies

The secondary market for life insurance policies will not vanish. It has contracted – as have so many other financial industries – as a result of the credit crunch, but it is still viable. The major reason: if you are 75 and older, own life insurance, and need cash, selling to a life settlement company often yields more than surrendering the policy to the insurer for its cash value. It is certainly much more advantageous than simply letting a policy simply lapse. The stance being taken by the majority of the issuing life insurance industry needs to be reconsidered.

First, rather than fighting the secondary market, policy issuers could use its existence as a marketing tool to sell more policies, just as Aaron Agent did. It is a strong inducement for potential insureds to buy the issuers' product – and the more expensive whole and universal life policies, rather than term insurance. Life insurance is easier to sell when the potential insured learns he has more options than holding the policy to maturity, borrowing against it, or cashing it out.[25]

Second, life insurance is a contract. The issuing insurance companies could provide, for themselves or an affiliated company, a right of first refusal to purchase the policy. That is, at its option, an issuing life insurance company (or its affiliate) could buy the policies back themselves, eliminating the need to pay out a death benefit.

Third, some thoughtful insurance companies may consider it worthwhile to have their own premium finance company to induce sales of their products. Also, an issuer may find it worthwhile financially to have an affiliated life settlement company.

In other words, if you can't lick 'em, join 'em. Such a company could buy policies on the secondary market, and the issuer could eventually pay the death benefit to itself or its affiliate.

Finally, the insurance companies should realize that life expectancy determinations, according to companies in that business,[26] have increased by over 20 percent as life expectancies in America continue to increase, the effect on insurance companies is a longer period of premium payments. This may cut into the profits of the life settlement companies, but conversely, it increases the life insurance issuer's profits.

For all of these reasons, life insurance policy issuers may wish to re-examine their negative outlook on the life insurance settlement business. ■

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20. See http://en.wikipedia.org/wiki/Life_settlement, on discussion of types of policies.

21. Holman W. Jenkins, *Life Insurers Face the Future, Grudgingly*, Wall Street Journal, Aug 9, 2006.

22. "The ING Life Companies are committed to protecting against illegitimate investor-originated life insurance (IOLI) and stranger-originated life insurance (STOLI) arrangements. ING Life New Business and Policy Services are taking important steps to monitor, identify, and respond appropriately to address the arrangements." E-mail from ING Life Sales Promotion, May 15, 2008.

23. SOLI is an acronym for Stranger Originated (or "Owned") Life Insurance.

24. Alan H. Buerger, *Life Settlements Come of Age*, Trusts & Estates, Nov 2002, available at http://www.thesafeinvestment.com/downloads/medialibrary/TrustsNEstates.pdf. Also see The Wall Street Journal, Page 1, Nov 26, 2007, and *Understanding Life Settlements and Industry Issues Entering 2008*, Insurance Studies Institute, January 22, 2008, Page 7.

25. Neil A. Doherty and Hal J. Singer, *The Benefits of a Secondary Market for Life Insurance Policies*, October 14, 2002, available at http://knowledge.wharton.upenn.edu/paper.cfm?paperID=1132, "…the life insurance industry would benefit in the long term from stronger demand created by the secondary market."

26. Mortality Table of 21st Services on September 2008, available at http://www.21stservices.com/articles/CDRG-Study-White-Paper-02-11-09.pdf. The Life Settlement Report of January 9, 2009 stated, "ICS is the third life expectancy company to lengthen its mortality figures since September. 21st Services of Minneapolis lengthened its life expectancy estimates by 20% to 25% in mid-September. AVS Underwriting of Kennesaw, Ga, lengthened its estimated by almost 16% in mid-November."

> Longer life expectancy estimates may reduce the prices investors will pay for policies, as policies take longer to pay out when insureds live longer.