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Life Insurance: Think Before You Sell Your Policy for Cash

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It's no wonder why many older adults are considering selling their life-insurance policies to strangers: They're looking to shore up their finances. After all, the economy is slumping and the stock market is in a 10-year funk. The strategy, though, might not make as much sense as it did a few years ago, thanks to a steep decline in the prices investors are willing to pay for policies.

In a so-called life-settlement transaction, an investor buys a stranger's life-insurance policy for a lump sum and continues paying the premiums until the policyholder dies, at which point the investor collects the death benefit. The sooner the insured person dies, the greater the return to the investor.

The cash windfall may sound great. But before making a deal, consult a trusted adviser. There may be better options for any policy you own, and commission-paid brokers may not volunteer these alternatives or even understand them themselves.

There also are taxes to consider. A 2009 Internal Revenue Service ruling raised the tax bill for many who sell their policies.

The life-policy secondary market dates back to the 1980s, when AIDS patients sold their policies to raise cash for medical treatments. In recent years, it has evolved into a place for older adults to unload "permanent" life policies—designed to be in place until the policyholder dies, rather than for a specified number of years—they no longer need or can afford.

Hedge Funds Pile In

The market boomed earlier this decade, as hedge funds eager for offbeat alternative investments piled in. With demand keen, older adults typically netted more than they could by surrendering a policy to the insurer for a lump-sum payment.

But things have changed since the credit crisis of 2008-09, and investor enthusiasm for life settlements has yet to recover. After growing rapidly, the total face value of policies purchased in the secondary market fell to \$7 billion in 2009 from \$13 billion in 2008, according to industry estimates.

Prices for policies, meanwhile, fell to an average of 13% of the death benefit in 2009 from 21% in 2006, according to a

recent report by the U.S. Government Accountability Office.

Various factors, including investors' concern about the reliability of life-expectancy estimates, have contributed to "make this current market a buyer's market," says Doug Head, executive director of Life Insurance Settlement Association, a trade group in Orlando, Fla.

The bottom line: "You should think very carefully before you decide to sell," says Richard Connolly, an insurance agent at Ward & Connolly in Columbus, Ohio. With buyers often making stingy offers, "we believe there is often a strong economic case for policyholders to hold on to their policies, provided they have the wherewithal to keep them in force."

Options for Sellers

There are several alternatives to life settlements. Policyholders can often withdraw or borrow funds from a policy or restructure the coverage to make premiums more affordable, for example. There also are tax-efficient ways to exchange one policy for another one that might better suit your current needs, such as a retirement-income annuity.

With a well-conceived strategy, a policyholder can free up cash while preserving at least some portion of the death benefit for heirs, says Caleb Callahan, vice president of investments at ValMark Securities Inc., an Akron, Ohio, independent broker-dealer that specializes in life insurance.

Which option makes the most sense depends on factors including the policyholder's financial goals and health and whether the policy has "cash value," which is a form of savings that accumulates inside permanent-life policies.

If your policy has built up a lot of cash value and you want to access it, you can take out a loan against it. Under New York Life Insurance Co.'s Access Plus program, for instance, clients who are 65 or older and meet certain health requirements may be able to borrow even more than a policy's cash value. As with other types of loans, borrowers must repay the principal and interest, or heirs will see those amounts deducted from the death benefit.

Instead of taking out a loan, consumers with certain types of policies can withdraw at least a portion of their cash value. Although this approach reduces the ultimate death benefit, says Mr. Connolly, it saves on interest expense.

There are caveats: Under some circumstances, loans or withdrawals can trigger tax bills, says Gary Cotter, a certified financial planner at Cotter Financial LLC in Sun City Center, Fla. Moreover, if you substantially erode your policy's cash value, you may face significantly higher premiums down the road, or your coverage will lapse.

'Accelerated' Benefits

Some policies also allow those with a terminal illness to take at least some of a policy's death benefit tax-free. To qualify for an "accelerated death benefit," a policyholder has to obtain a certification from a physician that his or her health condition could "reasonably be expected to result in death within 24 months," according to the IRS.

If you are too cash-strapped to continue paying premiums, some advisers recommend asking your heirs to cover all or a portion of the cost. Each heir can give you a maximum of \$13,000 this year free of gift tax.

Another option: Ask the insurer to scale back the death benefit to a level at which you can afford to make payments. Or keep the same death benefit, but reduce the period for which the coverage will be in force.

Susan Bruno, a certified public accountant at Beacon Wealth Consulting LLC in Rowayton, Conn., recently advised a 78-year-old facing a potential estate-tax bill to hold on to a \$3 million universal-life policy rather than sell it to investors for \$800,000. She recommended the family pay just enough—\$85,000 a year—to fund the policy for the next eight years.

If the policyholder lives longer, the family is likely to face substantially higher premiums. But given the policyholder's

health, the heirs are willing to take the risk, Ms. Bruno says.

Those who have paid more in premiums than they have amassed in cash value may want to consider a tax-free exchange of their policy for another type of coverage, such as a combination life-insurance and long-term-care contract or an annuity, says ValMark's Mr. Callahan.

Such a move can net substantial tax benefits. One client of Mr. Cotter's recently swapped a \$700,000 policy, which had a cash value of \$20,000, for a deferred annuity. The policyholder had paid \$100,000 in premiums, which meant there was an \$80,000 investment loss. As a result, the annuity can appreciate by \$80,000 before tax is owed on withdrawals.

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