Life Settlement Guide

What Is a Life Settlement?

In a life settlement, you sell your life insurance policy in exchange for a cash payment.

The buyer pays you a lump sum for your policy.

Buyers of life settlements are usually investors. They take over the premiums and receive the death benefit when you pass away.

How Does a Life Settlement Work?

First, you will consult with a life settlement broker. The broker will screen your policy to determine if it qualifies for a life settlement sale.

The broker considers your age and health when determining if you qualify. The face amount and type of policy issued are also considered. The broker will use other factors as well, such as the who issued the policy and the amount of any loans.

Should your policy qualify, the broker will then request that you complete an application. The application includes a medical release form and an authorization to contact your insurance company

Then the broker will present the policy to licensed buyers.

These licensed buyers are also known as providers.

Each buyer then calculates the value of your policy. The factors that determine the lump sum they pay include:

- the amount of the death benefit
- any medical conditions
- the cost of premiums
- any loans or advances taken against the policy, if applicable

- the rating of the issuing insurance company
- current interest rates
- your state's life settlement regulations

You may receive multiple offers. You decide which one to accept. If none are suitable, you can refuse all of them.

Should you choose an offer, you then transfer the policy to that buyer. The buyer becomes the policy's beneficiary upon transfer.

In return, the buyer puts your lump sum into an escrow account. You receive the money once the transfer of ownership is complete.

The life settlement process typically takes 8 to 16 weeks.

How Do You Qualify for a Life Settlement?

In order to qualify for a life settlement, certain criteria must be met. Typically, to sell your policy you must:

- be at least 65 years of age
- not be chronically or terminally ill
- hold a universal or whole life policy, or a term or variable policy that can be converted to a permanent one
- have a policy with a death benefit of at least $100,000

Some life settlement companies have different criteria but most follow the above guidelines.

Why Do People Sell Their Life Insurance Policy?

There are many reasons why people sell their policies.

You might consider selling your policy if you:

- cannot afford the premiums
- need to cover other expenses

- no longer need the policy
- hold a term policy that's about to expire
- have a term policy conversion privilege about to expire
- want to supplement your retirement income
- need to pay for long-term care
- bought a policy for a business you no longer own or run
- no longer have an estate tax liability

You may have more than one reason for selling your policy. For example, you may no longer need the policy. At the same time, you may need funds to pay for long-term care.

What are the Advantages and Disadvantages of a Life Settlement?

A life settlement has both pros and cons that need to be weighed carefully. While a life settlement can provide you with extra cash for expenses, it may not be the right choice for you.

Below is a list of the advantages and disadvantages that should be considered before completing a life settlement.

Advantages

Cash for Expenses

A life settlement can provide cash to pay your expenses. Since the money belongs to you, you can choose to spend it how you wish.

For example, the money can be used to pay for medical expenses or cover your mortgage.

You Stop Paying Premiums

A life settlement can help if you are struggling to pay your premiums. Along with receiving a lump sum payout, you stop paying your premiums once the sale is complete.

This can make sense if you no longer need your policy. You can use the amount you save to fund other needs in your life.

Disadvantages

Your Proceeds May Be Taxed

Any amount received above the premiums paid is usually taxed.

On the other hand, the death benefit usually passes to your beneficiaries tax-free.

Please consult with a tax advisor before making any decisions.

You Can Be Disqualified for Some Types of Government Support

A life settlement can place you in a higher income bracket.

This means you may become ineligible for:

- Medicaid
- SSI
- SNAP food benefits
- Section 8 or HUD housing benefits

It does not, however, affect eligibility for Medicare or SSDI (Social Security Disability Insurance).

What Are the Different Types of Life Settlements?

The most common life settlement options are traditional, viatical and retained death benefit.

Traditional Life Settlement

Traditional is the most common type of life settlement. You receive this type of settlement if you meet the criteria described above. You must also have a life expectancy greater than two years.

Viatical Life Settlement

Viatical settlements are similar to traditional life settlements. The difference is that they are for those whose life expectancy is less than two years.

Viatical settlements typically pay more than traditional life settlements. Buyers only have to pay the premiums for a short period of time. Therefore, they are willing to pay more.

If you have a terminal illness, you may qualify for a viatical settlement.

You may also qualify if your life expectancy is greater than two years. If you suffer from a chronic or serious illness, a viatical settlement may still be an option.

Retained Death Benefit Life Settlement

A retained death benefit (RDP) is when you sell a portion of your policy. You receive a smaller lump sum than if you were to sell the entire policy.

The buyer then becomes responsible for paying part or all of your premiums.

A portion of your policy's death benefit goes to the buyer. The remainder passes to your beneficiaries.

What Is the Life Settlement Transaction Process?

There are roughly seven steps in the life settlement process:

1) Estimate the Value of the Policy

A life settlement broker can help you with the process of selling your policy.

To begin, they ask you some initial questions. The four main factors they consider are:

1. your age
2. amount of the death benefit
3. the type of policy
4. your medical history

Ideal candidates are aged 65 or older. Your policy may qualify if you are younger than 65 and have a severe illness.

Buyers also look for policies with death benefits of at least $100,000. They require larger death benefits to cover their expenses.

Your policy must also be a whole life, universal life, or term life policy that can convert into a permanent policy. This policy can be an individual or group policy.

Finally, the buyer needs to know how long you've had the policy. Some states require that a policy be held for a certain number of years before selling. Each state has its own requirements.

2) Complete the Application

Next, you fill out a life settlement application. The application contains basic questions regarding you and your policy.

You also need to fill out a medical release form. The buyer needs your medical history for the past five years. The underwriter uses this information to calculate your expected lifespan. A shorter expected lifespan increases the amount a buyer will pay.

Finally, you complete an insurance company authorization form. This allows your broker to confirm the details of your policy with your insurance company.

3) Submit Policy To the Auction Market

A life settlement broker presents your policy to multiple buyers. This creates competition among buyers and helps you receive a higher price.

4) Review Bids on the Policy

Your broker then presents bids to you for review. Some brokers only share the highest offer.

You have time to review the bid(s), usually up to 30 days.

5) Decide to Keep or Sell the Policy

You may accept or decline any offer.

Should you accept an offer, the broker informs the buyer.

6) Complete Closing Documents

The buyer then sends a closing package to your life settlement broker.

The documents included in the package depend on the state in which you live. The package often includes three items: a contract, verification from the insurer that the policy is still active and a letter stating you are of sound mind.

You also have to sign documents changing ownership and the beneficiary to the buyer.

7) Receive Cash Payout

Once the buyer receives your closing package, they transfer your lump sum to an escrow account.

An escrow agent verifies the documents you signed. The buyer then completes the transfer of ownership.

The funds in the escrow account are then released to you.

How Is the Value of Your Life Insurance Policy Determined?

Buyers consider three main factors: life expectancy, the cost of keeping the policy in-force and the amount of the death benefit.

These factors determine the amount they offer.

Life Expectancy

The shorter your life expectancy, the more you receive for your policy. The buyer knows that they can receive the death benefit from your policy sooner.

Likewise, you receive less when you are expected to live longer.

The Cost of Keeping the Policy In-Force

Since the buyer takes over the premiums, your policy’s annual cost is a factor.

They offer more for policies with lower premiums. If your policy has higher premiums, you receive less.

The Death Benefit of the Policy

Perhaps the biggest factor is the amount of your policy's death benefit.

Most buyers only consider policies with a death benefit of at least $100,000.

Life settlements, on average, are usually 25% of the policy's death benefit amount. For example, if your policy's death benefit is 1 million, you would likely receive $250,000 in a life settlement.

Some policy owners receive as much as 60%, although this is uncommon.

Other factors beyond these three may affect the amount you receive. These include current market conditions and your policy's cash value.

Do I Owe Taxes If I Sell My Life Insurance Policy?

A life settlement usually incurs taxes. Therefore, taxes should be a factor when considering a life settlement.

How a Life Settlement Is Taxed

Any amount you receive above the total of premiums paid is subject to taxes.

An exception to this is if you have a life expectancy of less than two years. In this situation, you might be eligible for a tax-free transaction.

A portion of proceeds from a settlement is taxed as ordinary income. The rest is taxed as capital gains.

To better understand, you can break it into three sections:

- No taxes: the total of premiums paid on the policy
- Taxed as ordinary income: the amount of the cash surrender value minus the total of premiums paid
- Taxed as capital gains: the amount of the settlement minus the policy's cash surrender value.

An Example of Tax Liability

For example, let's say you receive a life settlement of $100,000. Your policy's cash surrender value is $90,000. You paid $75,000 in premiums:

Life Settlement: $100,000

Cash Surrender Value: $90,000

Premiums Paid: $75,000

You do not pay taxes on the total amount of premiums paid. In this case, that's $75,000.

You would, however, owe taxes on $25,000 of your life settlement:

$100,000 (life settlement)

- $75,000 (premiums paid)

= $25,000 taxed

Of this $25,000, $15,000 would be taxed as ordinary income:

$90,000 (cash surrender value)

- $75,000 (premiums paid)

= $15,000 taxed as ordinary income

Any amount you receive that is more than your policy's cash surrender value is taxed as long-term capital gains.

In this example, you would pay capital gains on $10,000:

$100,000 (life settlement)

- $90,000 (cash surrender value)

= $10,000 taxes as capital gains

You also want to keep in mind that a life settlement might put you into a higher income tax bracket.

A tax professional can help you understand your total tax liability for a life settlement.

How Are Life Settlements Regulated?

Currently, 42 U.S. states regulate life settlements. These regulations are overseen by the state's Department of Insurance.

Rules may include when you would receive your money or how the transfer of ownership takes place. Your state may also regulate how much commission your broker can receive.

If you reside in a state that regulates life settlements, a broker or buyer must follow these rules.

These rules are meant to protect you, the seller, as well as the buyer.

Policy Ownership Anniversary

Most states require you keep a policy for a minimum number of years. This prevents you from taking out a policy for the sole purpose of selling it.

If you live in one of the following states, you have to wait at least five years before you can sell your policy:

- DE, IA, ND, NE, NH, NV, OH, OR, VT, WI, WV

If you live in Minnesota, you have to wait at least four years.

These states do not regulate life settlements. Thus, no waiting period exists:

- AL, HI, MI, MO, NM, SC, SD, WY, as well as Washington D.C.

All other states require that you wait at least two years before selling.

You still may be able to sell your policy during the mandatory waiting period, if your state has one. Some of these states allow exemptions. Such events include recently retired or divorced or the death of a spouse. Other major life events may apply.

You can check with your state's Department of Insurance to find out its rules for life settlements. You can also consult with a financial advisor or life insurance broker licensed in your state.

Your Disclosures and Transparency

Most states have laws that require brokers and buyers to disclose important information to you. In other words, they must be truthful in the facts regarding your policy.

Your state may require your broker to inform you of:

- all offers, counter-offers, acceptances and rejections from buyers
- taxes you may owe from the sale
- your lump sum being subject to creditors' claims
- the rescission period, which is the number of days to change your mind after the sale
- the amount of their commission from the sale
- other options besides selling your policy

Broker Licensing

All life settlement brokers must hold a license in life insurance. They must also have an additional life settlement license. The license in life settlements usually requires the broker to have additional training and experience.

Depending on your state, your broker may also have a fiduciary duty to represent you. A fiduciary duty means they are legally required to work in your best interests, not the buyer's.

Be sure to check with your state's Department of Insurance to verify that your broker is properly licensed. You can also check with your state regarding your broker's fiduciary duty.

Life Insurance Settlement Association (LISA)

The Life Insurance Settlement Association (LISA) is a non-profit organization. It consists of brokers, buyers, financing entities and other service providers related to life and viatical settlements.

LISA educates consumers and advisors about life settlements.

The organization also promotes ethical practices in the industry. All LISA members must complete a rigorous vetting process before joining. They must also review and agree to their code of ethics and bylaws.

Finally, you can use the LISA website to find a broker or buyer to assist you in selling your policy. All brokers and buyers listed on the website are LISA members.

What Risks Should You Consider Before Doing a Life Settlement?

Risks to consider include fees, taxes and the needs of beneficiaries. Stranger-owned policies are also a risk.

Life Settlement Fees

Your broker earns a commission for helping to sell your policy. Their fee is a percentage of one of the following values:

- the death benefit of the policy
- the sale price of the policy
- the difference between the offer and the policy's surrender value

The most common percentage of broker fees is 6% of the policy's face value or 30% of the offer.

For example, if your policy's face amount is $500,000 and you receive an offer for $120,000, the fees could be calculated like this:

$500,000 X 6% of the policy's face value = $30,000

OR

$120,000 X 30% of the offer = $36,000

A broker usually charges the lesser of these two fees.

Taxes When You Sell Your Policy

As explained above, you may owe taxes. Any amount you receive above the total of premiums paid is subject to taxes.

An exception to this is if you are within two years of death. In this situation, you may be able to receive your proceeds tax-free.

Please consult with a tax advisor before making any decisions.

Leaving Beneficiaries With Nothing

If you sell your life insurance policy, you risk leaving loved ones without any life insurance proceeds.

A life settlement transfers ownership of your policy to another person or institution. This means your current beneficiaries lose the death benefit.

One option, as discussed above, is to choose a retained death benefit (RDB). An RDB allows you to keep a portion of the death benefit.

STOLI (Stranger-Owned Life Insurance)

Life insurance is meant to provide funds to those who suffer financial loss or hardship upon the death of the insured.

This financial loss or hardship is called insurable interest. Insurable interest is required when you initially purchase a life insurance policy for your beneficiaries.

Stranger-owned life insurance (STOLI) is when a person owns an insurance policy on another person whose death would not cause financial loss or hardship on the policyholder.

Some people invest in STOLI policies. However, due to the lack of insurable interest, stranger-owned life insurance is largely considered dubious.

Because of this, 20 states have banned them.

When considering a life settlement, it's important to be aware of persons who propose a STOLI arrangement. They may offer to take over your premiums and give you an upfront payment. In return, they ask for a transfer of the policy, or at least its benefits, to them.

Your policy's current beneficiaries would be removed from the policy.

If you have a STOLI policy, you may have trouble selling it. Due to their controversial nature, life settlement buyers avoid STOLI policies when purchasing on behalf of investors.

What Are Alternatives to Life Settlements?

Accelerated Death Benefit

One alternative to a life settlement is utilizing the accelerated death benefit (ADB) should your policy have one.

An accelerated death benefit allows you to take money from your policy, tax-free. It is deducted from the death benefit.

You do not need to pay back the money you withdraw. The amount of death benefit your beneficiaries receive is the original death benefit minus the amount of the withdrawal.

There are tight restrictions on when you can use an ADB. In some cases, it can only be exercised if you are terminally ill and have a life expectancy of less than two years.

You may also be able to use the ADB if you are dealing with a chronic illness and have difficulty with everyday activities. The everyday activities included are eating, bathing, dressing, mobility, maintaining continence and toileting.

The situations that apply are stated in your policy. Your insurance company or broker can help determine if you qualify.

Should you wish to use your ADB, you still need to pay your premiums to keep the policy in force.

Viatical

A viatical settlement is similar to a life settlement. You sell your policy to a third party in exchange for a lump sum. As with the life settlement, this amount is more than the cash surrender value but less than the death benefit.

The difference is that you must be terminally ill to use the viatical settlement option. Specifically, you must have a life expectancy of under two years.

You can sometimes qualify for a viatical settlement if you have a chronic illness.

One definition of chronic illness is the inability to perform at least two of the six activities of daily living. These daily activities include eating, bathing, dressing, mobility, maintaining continence and toileting.

A chronic illness may also be defined as having severe mental impairment.

Just like with a life settlement, the new owner of the policy takes over the premiums.

Policy Loan

If you need cash, you could consider a loan against your policy. This is known as a policy loan.

The loan comes from the cash value account of your life insurance policy. You are not required to repay the loan.

Should you not pay it back, the loan amount plus interest is deducted from the death benefit. As a result, your beneficiaries receive less. If the policy is loaned to its maximum amount, the policy will lapse. This lapse could cause a taxable event.

But a policy loan can still be a better alternative to selling the policy depending on your policy’s cash value and options.

Surrender the Policy

You might choose to surrender your policy for its cash value instead of choosing a life settlement.

Surrendering your policy may be an option if the surrender value is higher than the life settlement offer.

When you surrender your policy, you recieve your cash value but lose the death benefit.

You may be charged a surrender fee. Surrender fees vary and the older your policy, the less you pay. Policies ten years or older may not incur any surrender fees.

In exchange, you are given the policy’s cash surrender value. The cash surrender value is the amount in the cash portion of your policy plus any interest minus any fees and loans.

Who Is Involved in a Life Settlement?

Policy Owner

The policy owner is the person who bought the policy. The policy owner may also be the insured but not always.

Insured

The insured is the person whose death triggers the death benefit. When the insured dies, the beneficiaries receive money from the policy.

Life Settlement Brokers

Life settlement brokers facilitate the sale of a life insurance policy. They act on behalf of the policy owner. They are responsible for presenting policies to buyers to purchase.

Life Settlement Providers

Life settlement providers are the buyers of life insurance policies for sale. Some providers purchase policies directly while others buy them from brokers.

Insurance Company

The insurance company issued the policy.

Insurance companies accept premium payments in exchange for taking on risk.

Life insurance companies must legally pay the death benefit when the insured passes away. This death benefit goes to the beneficiaries listed in the policy.

Life Settlement FAQs

What is a life settlement?

A life settlement is when you sell your life insurance policy in exchange for a lump sum.

Buyers, also known as providers, pay you money for your policy. They take over the premiums and receive the death benefit when you pass away.

Do I qualify for a life settlement?

You may qualify for a life settlement if you:

- are at least 65 years of age
- are not chronically or terminally ill
- hold a universal or whole life policy, or a term or variable policy that can be converted to a permanent one
- have a policy with a death benefit of at least $100,000

However, criteria can vary. For example, a few life settlement companies accept policies with death benefits as low as $50,000.

To know if your policy qualifies, contact the company directly.

Does a life settlement have fees?

A life settlement does involve fees. The most common percentage of broker fees is 6% of the policy's face value (death benefit) or 30% of the sale price.

Who buys my policy in a life settlement?

Investors purchase life insurance policies. These investors are known as life settlement companies or life settlement providers.

The company that buys your policy will either hold onto the policy and collect the death benefit themselves or resell the policy to another investor.

Do I owe taxes on a life settlement?

You usually owe taxes on any amount received above the total of premiums paid.

Ordinary income tax applies to the cash surrender value minus the total of premiums paid

You pay capital gains tax on the amount of the settlement minus the policy's cash surrender value.

One exception to these rules is if your life expectancy is less than two years. If this applies to you then you may be eligible for a tax-free settlement.

What is the cash surrender value of a life insurance policy?

Cash surrender value (also known as surrender value) is the cash portion of your policy plus interest, minus fees and loans.

What is a death benefit?

The death benefit is the amount your beneficiaries receive when you die. The life insurance company is responsible for paying it.

What is the face amount of a policy?

The face amount is the purchased amount of the policy. It is the money intended for your beneficiaries.

The face amount does not include any loans or withdrawals taken from the policy.

Who determines my life expectancy?

Medical underwriters determine your life expectancy. They use your medical records, as well as statistical data to help them decide. The statistical data includes such details as age, gender, tobacco use, and the overall health of people who are similar to you.

What is the difference between a life settlement and a viatical settlement?

These two types of settlements are similar. Each involves the selling of a life insurance policy for a lump sum.

A life settlement applies if you have a life expectancy of two years or greater.

A viatical settlement is for those who suffer from a terminal illness. To qualify, you must have a life expectancy of less than two years.

You may also qualify for a viatical settlement if you suffer from a chronic condition, are mentally or physically impaired or struggle with everyday living.

How much do I get from a life settlement?

Life settlements pay more than the cash surrender value but less than the policy’s death benefit.

Buyers use various factors to determine how much to offer. They include your medical condition, the cost of premiums and the amount of the death benefit.

They also consider other factors such as the rating of the issuing insurance company and current interest rates.

The amount you receive can be anywhere from 10% to 60% of the death benefit. The average percentage paid is roughly 25%.

Do I still pay the premiums once my policy sells?

You do not pay the premiums once the policy sells. Your buyer becomes responsible for the premiums.

How long does the process take?

On average, the process takes 8 to 16 weeks. Sometimes it is expedited to a few weeks.

How do I get started on the life settlement process?

First, find a reputable life settlement broker. A broker can answer additional questions you may have and assess whether or not your policy qualifies.

You can also approach a buyer directly.

However, a broker has access to many buyers. They often get multiple bids for one policy. Therefore, they can usually get you the best price.

Can I change my mind one I’ve sold my policy?

A life settlement includes a rescission period. You can change your mind during this period. This is usually 15 days after the sale of the policy but is dependent on state regulations.

You can also change your mind anytime during the process, before the sale is final.

What are some advantages of a life settlement?

One main advantage is the lump sum you receive. There are no restrictions on how you use the cash. You can use the money to fund other life expenses or pay for luxuries. It’s up to you on how you use the money.

Another advantage is that you can stop paying the policy’s premiums once the sale is final. This can save you money, especially if you no longer need the policy.

What are some disadvantages of a life settlement?

You may owe taxes on your life settlement.

A life settlement can also disqualify you for government benefits, such as Medicaid, SSI, SNAP and Section 8.

Also be aware that creditors may have a claim to your life settlement proceeds.

Can I sell a portion of my policy?

Yes. This is called a retained death benefit (RDP). With a retained death benefit, the buyer takes over part or all of your premiums.

You receive a lesser amount than if you were to sell the whole policy.

When you die, a portion of the policy’s death benefit goes to the buyer. The remainder goes to your beneficiaries.

Can I sell more than one policy?

In most cases, yes. This is especially beneficial if you have several smaller policies. You can bundle the policies together to meet a buyer's minimum face amount, which is usually $100,000.

Which types of policies qualify for a life settlement?

The policy must be a universal or whole life policy, or a term or variable policy that can be converted to a permanent one.

It can be an individual or group policy.

Are there restrictions on how I use the money?

There are no laws on how you use the proceeds. Beyond paying the required taxes, you can use the money however you want.

Which states do not regulate life settlements?

1. Alabama
2. DC
3. Hawaii
4. Michigan
5. Missouri
6. New Mexico
7. South Carolina
8. South Dakota
9. Wyoming