When Life Insurance Is More Valuable as Cash

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THE children are grown. Each spouse — or a surviving spouse — has enough assets to last a lifetime. Yet a life insurance policy is still in force. It could be used to make gifts to those children now, a down payment on an inheritance, in effect.

Or, in another case, an older person with such a policy needs the money it represents not for heirs but for personal needs — perhaps to pay for long-term health care, to travel or just to make ends meet.

A life insurance policy is a financial instrument, an asset. Like all other assets, it has a value. There is not just the face value — what it will pay at the owner's death — but some lesser amount that a buyer may pay in order to collect the face value when the insured person dies.

The concept of selling rights to life insurance policies first appeared in the late 1980s, as the AIDS epidemic mushroomed. Some patients lost their jobs; others needed extra funds for medical treatment. Selling a life insurance policy could give someone with AIDS cash quickly.

Buyers of such policies sprang up, attracted because they believed most of the sellers had short life expectancies.

As AIDS was transformed from an almost-certain death sentence to a chronic disease, at least for many people in the United States, the need for such patients to raise cash for medical treatment subsided. And the market for such policies shrank as life expectancy rose.

But another category of people were willing to sell, those approaching their 70s, and there remains a pool of buyers. The sale of a life insurance policy is known as either a viatical settlement, if the holder is not expected to live more than two years, or a life settlement. They have different tax consequences, but the concept behind the two is similar, according to Gloria Grening Wolk, who has written three books on the subject, including "Cash for the Final Days" (Bialkin Books, 1997).

"Don't go with the first one that makes you an offer," Ms. Wolk said, likening that to accepting the first offer for a house. A successful sale is “like a traditional auction if people do it right,” she said.

Jonathan D. Pond, a financial planner in Newton, Mass., said selling a life insurance policy before death can sometimes make sense. “If you really need the cash, it’s certainly worthwhile to consider,” he said.

Mr. Pond counsels clients in need of money to first “look for other sources of cash,” like home equity loans, reverse mortgages and the surrender or loan value of whole-life insurance policies. But the typical policy, he said, reserves a substantial amount as a death benefit, even after a surrender, so the holder may not be able to get as much cash as a buyer would pay.

That payment depends on a variety of factors, said William E. Massey, senior tax analyst at Thomson Reuters, including “age, gender, health, life expectancy, type of policy and its cash value,” if any.

If a policy is not already paid for in full, the buyer typically takes over the payments.

The amount of money a seller ultimately receives may be affected by tax laws. Viatical settlements are not subject to income tax, Mr. Massey said, but life settlements are, and the amount depends on whether the policy has a cash value. He suggested that a would-be seller consult a tax professional to determine what the tax on a proposed sale or surrender would be, and which would be more beneficial.

States have been tightening regulation of settlement buyers.

There is “a legitimate purpose in viaticals and life settlements,” said Kim Holland, the insurance commissioner of Oklahoma, which passed a law in 2008 regulating settlement buyers. She said the state wanted sellers to act thoughtfully.

Oklahoma needed to address a spate of out-of-state buyers who solicited older residents and encouraged them to buy and then sell policies, offering perhaps $30,000 or $35,000 for rights to a $1 million policy, she said. The new law imposes a two-year holding period.

In New York, Gov. David A. Paterson signed legislation in November imposing regulations on life settlements; until then, only viatical settlements, involving sellers certified as unlikely to live for more than two years, were regulated.

Matthew J. Gaul, the deputy superintendent for life insurance at the New York State Insurance Department, said the new law, which would be fully effective on May 18, would provide state oversight over settlement companies.

There had been “abusive practices in the industry, by both purchasers and intermediaries” who recruited sellers, Mr. Gaul said.

Offering advice to potential sellers, Mr. Gaul said such sales were “something where consumers need to really comparison shop among different providers.”

"The offers they get can be different from provider to provider," he said.

Or, as Mr. Pond said, sellers need "a lot of education and a lot of homework" to get the best deal.