Robin & Peter on LIFE SETTLEMENTS

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The Tax Treatment of Life Settlements Revisited

In May of 2009, the IRS clarified its position on the tax treatment of life settlements by issuing Revenue Rulings 2009-13 and 2009-14. While Revenue Ruling 2009-14 deals only with the taxation of life settlement investors, Revenue Ruling 2009-13 deals with most everyone else who sells a policy. Both of these rulings contain some novel and questionable interpretations of tax law.

Not surprisingly, Revenue Ruling 2009-14 applied the so-called "transfer for value rule" to non-related third party buyers, holding that life settlement investors must recognize as taxable income the amount by which the death proceeds exceed their cumulative premium payments plus what they paid for the policy. It was also ruled that the gain was ordinary income and not capital gain. Illogically, the ruling held that any gain on resale by a life settlement investor, prior to the insured's death, would be treated as capital gain. This leads to the rather bizarre situation where an investor can avoid ordinary income tax treatment by selling a policy just prior to death.

Of more importance to those of us who represent sellers of policies, not investors, is Revenue Ruling 2009-13. For sellers other than investors, the ruling confirmed that gain up to cash surrender value is ordinary income, but the gain in excess of cash surrender value could be treated as capital gain. The ruling, however, changed the way policy basis is calculated and came up with an illogical and artificial distinction between policies that are sold and policies that are surrendered.

The basis for a policy that is surrendered is the cumulative premiums (less any withdrawals, surrenders, or dividends taken in cash). The IRS ruled, however, that the basis for a policy sold by a non-investor is cumulative premiums minus cumulative cost of insurance (COI) charges. This distinction is just plain bad tax law for a variety of reasons:

- There has never been any need or requirement for insurers to keep track of these charges. As a result, the cumulative cost of insurance charges are frequently not available - what's a seller to do?
- What are the cost of insurance charges for a whole life policy? What about a policy that has been 1035 exchanged?
- Subtracting the COI charges from the cumulative premiums could produce a negative number. Is it possible for a policy to have a negative basis?

- Why should a senior who sells a policy be in a potentially worse tax position than one who surrenders a policy? What purpose does such tax policy serve? Although, generally, the additional proceeds of a life settlement should offset the additional taxes, there are situations where it will not. In those situations, the rulings have created a lose/lose situation. The seller loses by getting less for their policy and the government loses tax revenue because the policy is surrendered, rather than sold for a higher amount, which would usually generate some additional tax.
- While the ruling distinguishes between investors and other sellers, the hidden danger is that this ruling, logically, would also apply to non-life settlement transfers or sales. One trap, for example, would be for a business that sells or bonuses a policy to a key employee at retirement. Under the IRS's artificial distinction between sale and surrender, such a transaction, since it is not a surrender, could require the business to recognize significant additional taxable income.
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As long as we have to live with these rulings, prior to closing a transaction, the client should be instructed to request the cumulative COI charges from the insurance company. They should not wait until after the transaction closes because the insurer may be unwilling to deal with them once they are no longer listed as the owner of the policy. Although the increased value brought by a life settlement will often more than offset the tax consequences, there are some situations where it will not, particularly older policies that only sell for a small premium over the surrender value.
While the life settlement industry is pushing for reconsideration of the rulings or legislative relief, in the meantime, we must help our clients deal with the rulings as they currently exist. Our tax estimator worksheet may be helpful to you and your clients as you take into account the tax consequences of a life settlement transaction. This worksheet is just one more way we provide first class support for our producers and their clients.

As situations come up, don't let your senior clients lapse or surrender a policy without investigating the possibility of a life settlement. Remember, it always pays to ask, so don't hesitate to give us a call.

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