Robin & Peter on LIFE SETTLEMENTS

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New IRS Ruling on Tax Treatment of Life Settlements

In Revenue Ruling 2009-13, the IRS clarified the previously uncertain **seller's** tax treatment in a life settlement transaction. The ruling is effective for sales that are completed on or after August 26, 2009.

The IRS answered three major questions dealing with life settlement taxation:

1. What is the basis of a life insurance policy for purposes of a sale rather than a surrender or lapse?
2. Does a term policy have a basis?
3. What is the character of the income - ordinary or capital gain.

On the first question, **the IRS ruled that the basis, for purposes of a sale, is the cumulative premiums less the value of the insurance coverage received.** For a universal life policy this value would be the cumulative COI (Cost of Insurance) charges. This means that the basis for purposes of a sale is different than upon surrender. The basis upon surrender is the cumulative investment in the policy, but it is not reduced by the value of the insurance coverage. This determination by the IRS is different than what has previously been the generally accepted view.

Consistent with their response to the first question, the IRS ruled that the value of the term insurance coverage received equals the premiums paid. So term policies have no basis for life settlement purposes except for any unexpired portion of the term coverage that was prepaid. (For example, the client paid an annual premium, but the policy was sold mid-year.)

On the third question, **the IRS determined that amounts that exceed the basis in the policy are taxed on two-tiers: (1) Gain up to the policy cash surrender value is ordinary income and (2) Gain in excess of cash surrender value is capital gain.**

This example illustrates the taxation under the new ruling:

A universal policy has $30,000 in cash surrender value. Cumulative premiums paid were $100,000. Cumulative COI charges are $75,000. The policy is sold on the life settlement market for $65,000.

The basis for purposes of a sale is $25,000 ($100,000 minus $75,000). The total gain is $40,000 ($65,000 minus $25,000). $5,000 of the gain is ordinary income (the amount by which the cash surrender value exceeds the basis). $35,000 is capital gain.

As a result of this ruling, there are some especially important items that producers must keep in mind in advising their clients:

1. On a policy that sells for only a small premium over the cash surrender value, it is possible that the after tax proceeds of a sale could be less than the after tax proceeds of a surrender. When considering accepting an offer, the tax impact should be estimated.
2. **This ruling goes into effect for sales that close on or after August 26, 2009.** Clients who are on the fence about accepting a pending life settlement offer should be made aware that, by waiting, they would be subject to less favorable tax treatment.
3. Prior to closing a transaction, as soon as an offer is accepted, 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.

As sweeping as the ruling is, it leaves a number of unanswered questions:

- What if the issuing insurance company is unwilling or unable to provide the cumulative COI charges?
- How should the COI charges be calculated for a whole life policy?
- Is it possible to have a negative basis as cumulative COI charges could exceed premiums paid?
- Is this interpretation limited only to unrelated party transactions? What are the tax consequences to an employer who sells or bonuses a policy to a departing key employee?

Our take on the ruling is that it is mostly good news. Although the basis is less than previously thought, the good news is the confirmation of capital gain treatment for amounts received in excess of the cash surrender value. On the whole, **just eliminating the uncertainty is a good thing.**

Simultaneously, the IRS released Revenue Ruling 2009-14 which deals with the taxation of life settlement investors. **These rulings provide additional evidence that life settlements have joined the main stream.** Your clients may now participate in a life settlement with much greater confidence in the tax consequences of the transaction.

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