

Robin & Peter on LIFE SETTLEMENTS



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Tax Uncertainties Linger for Life Settlements

It's tax time again, which means yet another year has passed without clarity for life settlement transactions. In Revenue Ruling 2009-13, issued in May of 2009, the IRS attempted to clarify the tax treatment for consumers who sell a policy in a life settlement, but their questionable interpretation of the Internal Revenue Code raised as many questions as it answered. Unfortunately, neither the IRS nor Congress has seen fit to address those issues.

On the plus side, the ruling confirmed that for sellers other than investors, gain up to cash surrender value is ordinary income, but the gain in excess of cash surrender value is treated as capital gain. However, the ruling came up with an illogical and artificial distinction between policies that are sold and policies that are surrendered and changed the way basis is determined for policies that are sold. Indeed, the IRS apparently believes the Internal Revenue Code intended that seniors who surrender their policy to an insurance company deserve better tax treatment than those who sell their policy in a life settlement transaction!

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 policy owner (other than by a life settlement investor) is further reduced by cumulative cost of insurance (COI) charges. This distinction, read into the tax code by the IRS, is troublesome 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 COI charges are frequently unavailable - what's a seller to do?
- Unlike universal life, whole life policies work differently and there are no explicit cost of insurance charges for whole life.
- What about a policy that has been 1035 exchanged? Would the seller have to obtain COI charges from not only the current company, but also one or more prior companies?
- Subtracting the COI charges from the cumulative premiums could produce a negative number. Is it possible for a policy to have a negative basis?

- Finally, 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 more than offset the additional taxes, there are situations where it will not. In those situations, the ruling has 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.

A hidden danger of the revenue ruling is that it could 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.

Since we have to live with these rules for now, the client should be instructed to request the cumulative COI charges from the insurance company (assuming it has them) before closing the life settlement transaction. They should not wait until afterwards 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 usually 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. Knowing the COI charges will help the client estimate the tax consequences of the transaction. We have created a worksheet for this that is available upon request.

Another murky situation is a retained death benefit, which is being offered by providers as an alternative to a cash-only life settlement. These transactions allow the policy owner to retain some portion of the death benefit, free of additional cost, as part of the selling price in lieu of some or all cash, while the buyer is responsible to pay all future premiums to maintain the policy. Unfortunately, from a tax standpoint, this feature only compounds the ambiguities facing life settlement transactions.

In addition to the previously discussed tax questions, there has been no guidance on how to determine the value to the seller, for tax purposes, of the retained death benefit being paid for by the buyer. While the transaction clearly has tax implications to the seller, there are many theories under which the retained death benefit can be taxed. Some theories, like split dollar or annuity-type treatment, would cause the client to incur ongoing taxable income. Others could add significantly to the value of the sales proceeds for tax purposes by capitalizing the value of the death proceeds to be received in the future.

The unknown, and possibly unexpected, tax consequences for these transactions can be quite troublesome since many sellers engage in a life settlement because they are cash-strapped. This is particularly burdensome if the transaction provides little or no cash, which is not unusual in a retained death benefit transaction.

Although the retained, so-called "no-cost," death benefit clearly has value, the providers who handle life settlement transactions for the buyers (at their own peril) generally don't include any value for the retained death benefit in the 1099s they issue to the sellers. This means the sellers must make that determination themselves, with little or no guidance

from the IRS.

A life settlement can be a highly valuable alternative to surrendering a policy that is no longer wanted, needed, or affordable. However, complicated tax issues are raised due to the uncertainties created by the IRS ruling. It is hoped that Congress or the IRS will clarify the unanswered questions and make the taxation more fair to seniors, but, in the interim, clients should seek the advice of their tax advisors to avoid unexpected tax consequences.

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Contact us:

Robin S. Weinberger, CLU, ChFC, CLTC

(617) 451-3343

Peter N. Katz, JD, CLU, ChFC

(860) 673-3642

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Robin and Peter, 56ButtonwoodHillRoad,Avon,CT06001