Robin & Peter on LIFE SETTLEMENTS

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Recent Revenue Ruling: Favorable Life Settlement Tax Treatment and Clarification of Term Insurance Basis

The Tax Cuts and Job Act of 2017 (TCJA) made the income tax treatment of the sale of a life insurance policy in a life settlement more favorable to the seller. A recent revenue ruling issued by the IRS, Rev. Rul. 2020-05, confirmed the TCJA's more favorable tax treatment and clarified the tax basis of term insurance.

An issue that has been long debated in the life insurance community is whether a term insurance policy can have a tax basis. The revenue ruling clearly says that it does – the cumulative premiums paid.

Here is the background on how we got here, as well as a complete explanation of the tax treatment of life settlements. In 2017, after more than 8 years, the IRS's poorly reasoned and unworkable ruling on the taxation of life settlements to policy sellers was retroactively overturned by the TCJA.

When Revenue Ruling 2009-13 was published in 2009, the IRS created a distinction in the tax basis between policies that are surrendered and policies that are sold in a life settlement. For policies that are surrendered at a gain, the law has long been that the policy owner's basis is their cumulative investment in the contract, which is basically the cumulative premiums paid less withdrawals and dividends taken from the policy. But for purposes of a life settlement, the IRS ruled that the basis would have to be reduced by the cumulative cost of insurance charges assessed against the policy.

For no fathomable reason, the 2009 ruling put the seller in a life settlement transaction in a less favorable tax position than someone who surrendered a policy to the insurer. Thanks to the TCJA that's no longer the case. The act provides that policyholders who sell their policy in a life settlement transaction are *not* required to reduce their basis by the cumulative cost of insurance charges. So their tax basis is now the same as a policyholder who surrenders their policy to the insurance company. And, importantly, the change was made retroactive to 2009.

TCJA returned the tax treatment of a life settlement to what it had been widely believed to be prior to the ruling. A policyholder who sells a policy in a life settlement is generally taxed in three tiers as follows:

1. Amounts received up to the tax basis are received free of income tax,

2. Amounts received in excess of the tax basis up to the amount of the cash surrender value are taxed at ordinary income rates, and

3. Amounts received in excess of the cash value get favorable capital gains treatment.

Furthermore, with respect to the basis for term insurance, the ruling seems broad enough that it could apply not only to life settlements, but also to policies that are simply surrendered. So a cash value permanent insurance policy, that was originally bought as term and converted, can, apparently, include the premiums paid before it was converted to calculate any possible gain on surrender.

Finally, the revenue ruling also reiterated a long-standing principle that, where a policy is surrendered at a loss, there is no loss for tax purposes unless the policy was bought for profit (rather than protection) under IRC Section 165.

IRS, Rev. Rul. 2020-05, relieved a concern that some potential sellers may have had and increases the opportunity that a term life settlement can represent. Term policies most often lapse as they get to the end of the level premium paying period and/or the conversion period. Each of these situations represent one more opportunity to do something good for your policyholders and should be explored to see if there could be settlement value.

Please give us a call to discuss these policies, ideally about 4-5 months before they will lapse. On behalf of your policyholders, you certainly don't want to leave money on the table and, as we are often heard to say, "it can't hurt to try – it can only hurt not to."

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