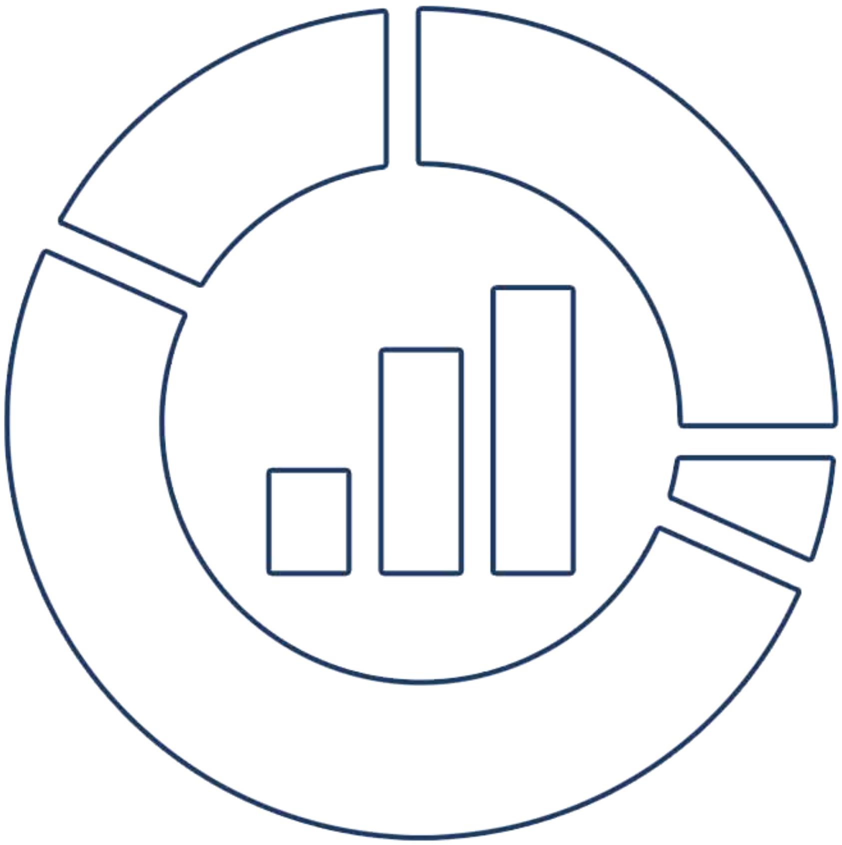
LIFE SETTLEMENT TAX GUIDE



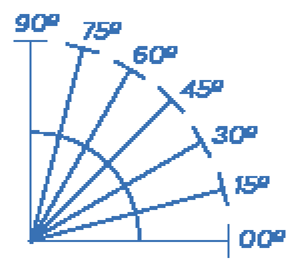
Brianne DeSellier, J.D., CPA, LL.M.
&
SETTLEMENT BENEFITS ASSOCIATION

LIFE SETTLEMENT TAX GUIDE

Life Settlements continue to gain momentum as a financial planning tool. Several court decisions have protected consumers' ability to sell a life insurance policy and state insurance departments are keeping close guard over the institutions that are allowed to purchase these policies. Industry participants, government agencies, and consumer advocates have helped shape this new mechanism in a way that offers consumers new options and provides various consumer protections. Moreover, the buyers are developing flexible structures that provide even more advantages to owning life insurance.

Combing these conditions with a low interest rate environment, we now have a thriving secondary market for life insurance policies. Consumer demand for the benefits available through the sale of a life insurance policy shows that this idea provides value for all parties involved.

Often, the biggest hurdle in pursing the sale of a life insurance policy revolves around the potential taxation of any proceeds from the transaction. To make a fair and accurate analysis of any life settlement options, policy owners and insureds must understand how the transaction can impact their bottom line. Furthermore, like most things related to the tax code, the answer is not always simple.



This situation is why we at Settlement Benefits Association, a Life Settlement broker that represents consumers in these transactions, developed this guide as another way to help consumers understand and maximize the value of their life insurance. The guide is free and shareable because it contains valuable information that can be used by policy owners and their tax planners/advisors to begin the process of accounting for these transactions. Of course, as Life Settlement brokers, we are clearly not tax professionals and we are not qualified to offer tax advice. All tax questions should be researched independently and discussed with a qualified tax professional.

We have partnered with one such professional, Brianne DeSellier, J.D., CPA LL.M. Mrs. Desellier is a member of the Florida Bar and a licensed Florida CPA. She holds a BBA in Accounting from the University of Miami, a J.D. from St. Thomas University School of Law, and an LL.M from New York University School of Law. She regularly appears on national news networks to weigh in on high-profile cases and other business and legal issues making headlines. Her legal commentary has been featured on HLN, CNN, NPR, Good Morning America, and ABC World News.

Mrs. Desellier's article, which begins on this next page of this guide, includes lots of important information and provides a discussion of several the main tax aspects of a life settlement transaction. As always, specific tax advice can only come from a qualified CPA or tax attorney reviewing your individual situation. Life Settlement advice comes from a licensed Life Settlement broker, and tax advice should come from the proper tax professional.

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TAX ASPECTS OF LIFE SETTLEMENT TRANSACTIONS

By: Brianne N. DeSellier, J.D., CPA, LL.M

From a tax perspective, there are two basic types of life insurance settlement transactions:

(1) the sale of a life insurance policy on the life of an individual who suffers from a terminal or chronic illness (commonly referred to as a "viatical settlement"); and

(2) the sale of a life insurance policy on the life of an individual who does not suffer from a terminal or chronic illness (commonly referred to as a "life settlement." Although some state insurance departments utilize slightly different definitions and the term "life settlement" is also commonly used as broader term encompassing both basic types of life insurance settlement transactions, for the purposes of this guide, we will use "life settlement" to refer only to this basic type of life insurance settlement transaction).

Significantly, the sale of a policy on the life of a terminally or chronically ill individual may implicate different tax consequences than a policy on the life of an individual who is not terminally or chronically ill. Consequently, the first step of the tax analysis should be to identify the type of life settlement transaction involved as either a viatical settlement or a life settlement.

I. *Viatical Settlement Transactions*

A. Sale of Life Insurance Policy Covering "Terminally Ill" Individual

The Internal Revenue Code creates a special rule with respect to amounts received under life insurance contracts on the lives of terminally ill individuals. Pursuant to Section 101(g) of the Internal Revenue Code, if a life insurance policy on the life of a terminally ill individual is sold or assigned to a viatical settlement provider,[2] the amount paid to the policy owner shall be treated as paid "by reason of the death of such insured."[3] Significantly, amounts received "by reason of the death of the insured" are generally not taxable.[4] As a result, if a life insurance policy covering a terminally ill individual is sold to a viatical settlement provider, the proceeds received should be exempt from federal taxation.[5] The Section 101(g) exclusion of viatical settlement proceeds from taxable income generally applies whether or not the recipient of the proceeds is the terminally ill insured.[6] However, exceptions

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[2] For tax purposes, a "viatical settlement provider" is generally defined as any person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally or chronically ill individuals if that person is licensed for those purposes, with respect to the same type of ill individuals as is the insured, in the state in which the insured resides. I.R.C. § 101(g)(2)(B)(i)(I). If the insured resides in a state not requiring such licensing, then special rules apply. *See* I.R.C. § 101(g)(2)(B).

[3] I.R.C. § 101(g)(2). *See also* Prop. Treas. Reg. § 1.7702-2(c)(2).

[4] I.R.C. § 101(a)(1); Treas. Reg. § 1.101-1(a)(1).

[5] I.R.C. § 101(g)(2)(A). Note that tax-free treatment should apply despite I.R.C. § 61(a)(10), which explicitly states that taxable income includes income from life insurance contracts. *See* Treas. Reg. § 1.61-1(b) (stating that to the extent that another section of the Code or regulations provides specific treatment of any item of income, that other provision applies notwithstanding § 61). Since I.R.C. § 101(g) specifically provides for tax-free treatment for viatical settlement proceeds, that provision controls.

[6] *See* RIA Checkpoint Estate Planning Analysis, *Accelerated Death Benefits Received by Terminally and Chronically Ill Individuals* ¶ 43,546 (stating that the Section 101(g) exclusion from income applies whether or not the recipient is the insured, unless exception applies). *See also* BNA Portfolio 546, *Annuities, Life Insurance, and Long-Term Care Insurance Products,* Section III.D; Frank J. Rief, III, *Life Insurance Planning and Techniques,* ALI-ABA Course No. SH069 (April 2003; May 2003) (available via Lexis Nexis).

exist where viatical settlement proceeds received by a payee other than the terminally ill insured may be taxable. Accordingly, a tax advisor should be consulted to evaluate the proper tax treatment in cases involving payment of the proceeds to someone other than the terminally ill insured.

For tax purposes, a "terminally ill" individual is defined as an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death within twenty-four months from the date of certification.[7] For this purpose, the term "physician" has the meaning given to that term by the Federal Social Security Act[8] - i.e. a doctor of medicine (M.D.) or osteopathy (D.O.).[9]

B. Sale of Life Insurance Policy Covering "Chronically Ill" Individual

If certain statutory conditions are satisfied, the tax law treats accelerated death benefits received under a life insurance policy by a chronically ill individual as amounts paid "by reason of the death of the insured."[10] Consequently, if a chronically ill insured sells his or her life insurance contract to a viatical settlement provider,[11] the proceeds received may be exempt from federal taxation if certain conditions are satisfied.[12]

For tax purposes, a "chronically ill" individual is defined as an individual who has been certified by a licensed health care practitioner within the preceding twelve-month period as:

[7] I.R.C. § 101(g)(4)(A).

[8] I.R.C. § 101(g)(4)(D) (citing 42 U.S.C. § 1861(r)(1))

[9] 42 U.S.C. § 1861(r)(1). *See also* H. Rept. No. 104-496 (PL 104-191) at p. 122.

[10] I.R.C. § 101(g).

[11] For the definition of a "viatical settlement provider," see footnote 2, supra.

[12] I.R.C. § 101(g)(2)(A).

(1) unable to perform at least two "activities of daily living"[13] without substantial assistance for at least ninety days[14] due to a loss of functional capacity; or

(2) requiring substantial supervision due to "severe cognitive impairment" (*e.g.,* memory loss, disorientation).[15]

For this purpose, the term "licensed health care practitioner" includes physicians, registered professional nurses, and licensed social workers.[16] Thus, unlike the "terminally ill" certification, which can only come from a licensed physician,[17] a "chronically ill" certification can come from a physician or certain types of non-physician health care providers.

As previously alluded to, additional limitations are placed on the ability to exclude viatical settlement proceeds from federal taxable income when the insured is a "chronically ill" individual. Most significantly, the Section 101(g) exclusion only applies to viatical settlement proceeds received by a chronically ill insured if the proceeds are used to cover qualified long-term care costs that are not compensated

[13] For tax purposes, "activities of daily living" include – eating, toileting, transferring, bathing, dressing, and continence. I.R.C. § 7702B(c)(2)(B).

[14] Note that this ninety-day period is not a waiting period. That is, it is not necessary for an individual to be unable to perform daily living activities for ninety days prior to becoming eligible for certification as "chronically ill." For tax purposes, an individual can be certified as "chronically ill" if a licensed health care practitioner certifies that the individual *will* be unable to perform at least two activities of daily living for at least ninety days. *See* Joint Comm. On Taxation 12-96 (Dec. 18, 1996) (indicating that the certification may occur at any time and that the certification is intended to take into account the sum of continuous prior days when the individual was "chronically ill" *and future days* when the individual is expected to remain "chronically ill").

[15] I.R.C. § 101(g)(4)(B); I.R.C. § 7702B(c)(2). The "severe cognitive impairment" standard referred to in item (2) above means that physically able individuals who suffer from cognitive conditions – such as Alzheimer's disease – can be treated as "chronically ill" for tax purposes.

[16] I.R.C. § 101(g)(4)(B); I.R.C. § 7702B(c)(4)

[17] I.R.C. § 101(g)(4)(A).

for by insurance or otherwise.[18] In this respect, three things must be established in order for long-term care costs to be "qualified" for tax purposes:

(1) the expenses must be incurred for necessary diagnostic, preventative, therapeutic, curing, treating, mitigating, rehabilitative, or maintenance/personal care services;

(2) such services must be required by the chronically ill individual; and

(3) such services must be prescribed by a licensed health care practitioner pursuant to an overall plan of care.[19]

In addition, certain other technical conditions must be satisfied in order for viatical settlement proceeds to qualify for tax-free treatment for a chronically ill insured –

(1) The contract under which the viatical settlement payment is made must satisfy certain requirements specified by the IRS as applicable to life insurance contract purchases, assignments or other arrangements.[20]

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[18] I.R.C. § 101(g)(3)(A)(i). Note that long-term care services that would be covered by insurance but for deductible or coinsurance limitations are generally considered to be covered by insurance and are, therefore, considered to be disqualified expenses for tax purposes. *See* I.R.C. § 101(g)(3)(A)(ii)(I) (referencing I.R.C. § 7702B(b)(2)(B)(i)).

[19] I.R.C. § 101(g)(4)(C) (referencing I.R.C. § 7702B(c)(1)).l

[20] *See* I.R.C. § 101(g)(3)(A)(ii)(II) (referencing I.R.C. § 101(g)(3)(B)(i)).

(2) The contract under which the viatical settlement payment is made must satisfy any standards adopted by the National Association of Insurance Commissioners (NAIC) that specifically apply to chronically ill individuals.[21]

(3) The contract under which the viatical settlement payment is made must satisfy any standards adopted by the state in which the policyholder resides.[22]

It is important to be aware of these additional requirements; however, an in-depth analysis is somewhat complex and beyond the scope of this guide. Taxpayers should consult with a tax advisor to obtain advice tailored to their circumstances to determine whether all necessary statutory conditions are satisfied in order for viatical settlement proceeds to qualify for tax-free treatment under Section 101(g).

C. Example

The following example illustrates the application of the rules and concepts relating to viatical settlements discussed in Sections I.A. and I.B above.

> On January 1, 2009, a 49-year-old male entered into a $2 million term life insurance contract. The annual premium paid by the insured on the policy was $6,920, or $577 per month. On June 30, 2013, the insured sold the policy for $1,050,000 in a life settlement transaction. Prior to the June 30, 2013 sale date, the insured had received an accelerated death benefit of $250,000 so that total coverage was $1.75 million on the date of the sale.

[21] *See* I.R.C. § 101(g)(3)(A)(ii)(II) (referencing I.R.C. § 101(g)(3)(B)(ii)). Note, however, that if any such standards are adopted by the NAIC, corresponding requirements specified by the IRS as applicable to life insurance contract purchases need not be satisfied by the contract. *Id.*

[22] *See* I.R.C. § 101(g)(3)(A)(ii)(II) (referencing I.R.C. § 101(g)(3)(B)(iii)). Note, however, that if any such standards are adopted by the state, corresponding requirements adopted by the NAIC or specified by the IRS as applicable to life insurance contract purchases, assignments or other arrangements need not be satisfied by the contract. *Id.*

> At the date of the life settlement transaction, the insured had an official[23] life expectancy range from 12 months to 102 months and required assistance with several "activities of daily life" due to a prior brain aneurysm rupture.

The amount realized by the insured on the sale of his life insurance policy is equal to the $1,050,000 in proceeds received by the insured. As discussed in more detail below, a policy holder will generally have zero tax basis in a term life insurance policy since a term life insurance policy has no cash surrender value. Accordingly, the gain realized by the insured would be $1,050,000 [$1,050,000 sale proceeds – 0 basis]. However, if the insured qualifies as terminally or chronically ill, the proceeds will be tax-free such that none of the $1,050,000 of realized gain will have to be recognized for tax purposes.

1. Is The Insured "Terminally Ill"?

The facts indicate a life expectancy ranging from 12 months to 102 months. In order to be considered "terminally ill" for tax purposes, the insured would have to obtain certification from a physician stating that his condition can reasonably be expected to result in death within twenty-four months from the date of certification.[24] If the insured obtains such a certification, then the proceeds would be tax-free under Section 101(g) of the Internal Revenue Code. If, however, the insured is unable to obtain such certification, it is necessary to determine whether the insured can be considered "chronically ill" for tax purposes.

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[23] As previously explained, an insured must obtain a certification of life expectancy from a healthcare professional in order to qualify as either "terminally ill" or "chronically ill." By stipulating an "official" life expectancy, this example assumes that the insured has obtained a certification of life expectancy from a qualified healthcare professional.

[24] I.R.C. § 101(g)(4)(A).

2. Is The Insured "Chronically Ill"?

The facts indicate that the insured requires assistance with several "activities of daily living." This would have to be confirmed for tax purposes by obtaining certification from a licensed healthcare practitioner stating that, due to a loss of functional capacity, the insured has been, or will be, unable to perform at least two "activities of daily living" without substantial assistance for at least ninety days. Once this certification is obtained, the sale proceeds should be tax-free for the insured as long as the proceeds are used to cover qualified long-term care costs which are not compensated for by insurance or otherwise.[25]

[25] I.R.C. § 101(g)(3)(A)(i).

II. LIFE SETTLEMENT TRANSACTIONS

Unlike viatical settlement proceeds, proceeds received by the seller of a life insurance policy in a life settlement transaction are not exempt from federal taxation. At the most basic level, the sale of a life insurance policy on the life of an individual who is not terminally or chronically ill is treated as an asset sale. Accordingly, the seller must recognize any gain realized on the sale.

This raises two subsidiary issues:

(1) How is gain/(loss) calculated?
(2) What is the character of the gain/(loss) – i.e. is it ordinary income vs. capital gain?

A. Calculation of Gain/(Loss)

1. Surrender of Life Insurance Policy

Under Section 72(e) of the Internal Revenue Code, proceeds received by a policy owner on the surrender of a life insurance policy are included in the policy owner's taxable income to the extent that the proceeds exceed investment in the contract.[26] For this purpose, the term "investment in the contract" means aggregate premiums paid as of the date of surrender, less any amounts previously received under the life insurance contract that were not included in taxable income (*e.g.,* dividends, distributions).[27] According to recent IRS guidance, the taxable gain would be the difference between the proceeds received on surrender of the policy and the aggregate premiums paid up to the date of surrender.[28] Note, however, that the rule appears to be different in the loss context.

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[26] I.R.C. § 72(e)(5).

[27] I.R.C. § 72(e)(6); Rev. Rul. 2009-13.

[28] Rev. Rul. 2009-13. Note that this assumes that no amounts were received under the life insurance contract prior to the surrender date (*e.g.,* dividends, distributions). If any such amounts had been received under the life insurance contract prior to the surrender date, then the taxable gain would

For purposes of calculating loss on the surrender of a life insurance policy, the taxpayer's "investment in the contract," or basis, must also be reduced by the cost of insurance protection consumed by the insured prior to the date of surrender.[29] The cost-of-insurance ("COI") concept is discussed in more detail in Section II.A.2.b below.

2. Sale of Life Insurance Policy

Under the Internal Revenue Code, taxable income includes gains derived from dealings in property.[30] In this respect, taxable gain is defined as the excess of the amount realized from the asset sale over the taxpayer's adjusted basis in the asset.[31] Thus, in order to determine the taxable gain arising out of the sale of a life insurance policy, it is necessary to determine two things: (1) the amount realized on the sale of the policy; and (2) the seller's tax basis in the policy at the date of sale.

The amount realized on the sale of a life insurance policy is simply the sum of money received by the seller.[32] The basis calculation on the other hand, while theoretically straightforward, can be complex and difficult to navigate. At the most basic level, a taxpayer's basis in an asset is equal to the total investment in that asset.[33] Based on that definition, many people incorrectly assume that the basis in a life insurance policy is simply equal to aggregate premiums paid. Significantly, however, most life insurance premiums have two components: (1) an investment component; and (2) an insurance component.[34] Aggregate premiums paid must be reduced by the cost

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be the difference between proceeds received and aggregate premiums paid as reduced to reflect amounts previously received under the life insurance contract.

[29] *See London Shoe v. Commissioner,* 80 F.2d 230 (2d Cir. 1935).

[30] I.R.C. § 61(a)(3)

[31] I.R.C. § 1001(a).

[32] I.R.C. § 1001(b).

[33] IRS Pub. 703, *Basis of Assets* (last updated April 2, 2013).

[34] A life insurance policy has a dual character in the sense that it provides a means of investment as well as present insurance protection. *London Shoe Co. v. Commissioner,* 80 F.2d 230 (2d Cir. 1935); *Century Wood Preserving Co. v. Commissioner,* 69 F.2d 967 (3d Cir. 1934). Thus, a portion of the

of insurance protection ("COI") consumed by the insured prior to the date of the life settlement transaction in order to accurately determine tax basis in the investment component of the policy.[35]

a. Term Life Insurance

A term life insurance policy has zero or minimal cash surrender value. This absence of cash surrender value represents the fact that a term life insurance policy has no investment component. Thus, substantially all term life insurance premiums are paid for insurance protection. For this reason, the IRS will generally presume that the COI for a term life insurance policy is equal to premium payments.[36] Consequently, a policy owner will typically have zero basis in a term life insurance policy; accordingly, all life settlement proceeds will constitute taxable gain.

b. Universal Life Insurance

Unlike term life insurance policies, which have zero or minimal cash surrender value, universal life insurance policies have a cash value buildup component which represents the policy owner's aggregate investment in the policy. As previously discussed, this investment value is calculated by reducing the aggregate premiums paid by the cost of insurance protection consumed prior to the date of the life settlement transaction. As a theoretical matter, this sounds straightforward enough; however, in practice, calculating COI can be complex.

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premium is being paid as an investment, and a portion of the premium is being paid for insurance protection.

[35] *E.g.,* Rev. Rul. 2009-13; CCA 200504001; *Standard Brewing Co. v. Commissioner,* 6 B.T.A. 980, 984 (1927); *London Shoe v. Commissioner,* 80 F.2d 230 (2d Cir. 1935). Note that aggregate premiums paid must also be reduced by any amounts previously received under the contract that were not includible in gross income (e.g., dividends, policy loans). *See* PLR 9443020; Rev. Rul. 2009-13; I.R.C. § 72(e)(6).

[36] Rev. Rul. 2009-13.

If possible, policy holders should try to obtain COI information directly from the insurance company prior to entering into a life settlement transaction. If the insurance company is unwilling or unable to provide this information, current tax law appears to provide support for two alternative methods of calculating COI. As one possibility for calculating COI, taxpayers can subtract the cash surrender value of their policy from the aggregate premiums paid.[37] Under this method, the tax basis of a life insurance policy will equal the policy's cash surrender value. Alternatively, actuarial tables which estimate the annual cost for term life insurance can be used to approximate COI.[38] Under this method, the tax basis of a life insurance policy will equal the difference between aggregate premiums paid and the estimated cost of term life insurance according to the actuarial tables. Both methods for calculating COI are merely approximations, and neither method is necessarily superior to the other. The most conservative approach would be to calculate basis under both methods and elect the method that produces the lower basis.

c. Sale of Policy Acquired in Section 1035 Exchange

Section 1035 of the Internal Revenue Code provides that no gain or loss shall be recognized on the exchange of a life insurance contract for another life insurance contract. If the life insurance policy being sold in the life insurance settlement transaction was acquired in a tax-free Section 1035 transaction, a question arises as to the tax basis in the life insurance policy for purposes of calculating taxable gain or loss. The basis of a life insurance policy received in a tax-free Section 1035 exchange is the same as the basis in the life insurance policy given up in the exchange transaction.[39] Thus, a taxpayer's basis in a life insurance policy which was previously acquired in a Section 1035 exchange would be equal to the taxpayer's basis in the old policy at the date of the Section 1035 exchange, as

[37] *London Shoe,* supra. *See also* PLR 9443020.

[38] The IRS has employed this method in the context of split-dollar policies. *See* IRS Notice 2002-8. In the absence of clear guidance for calculating COI and basis in the life settlement context, this approach can be borrowed for purposes of determining the basis of a life insurance policy.

[39] I.R.C. § 1031(d).

adjusted to account for any amounts received under the new policy (e.g., distributions, policy loans) and for the cost of insurance protection consumed prior to the sale of the policy.

B. Character of Gain/(Loss) on Disposition of Life Insurance Policy

1. Surrender of Life Insurance Policy

Although a life insurance policy is a capital asset in the hands of the policy owner,[40] the surrender of a life insurance policy does not produce capital gain.[41] The term "capital gain" is defined as gain from the *sale or exchange* of a capital asset.[42] Significantly, the surrender of a life insurance policy is not considered to be a "sale or exchange" for tax purposes.[43] Accordingly, the surrender of a life insurance policy does not produce capital gain.[44] As a result, any gain realized upon surrender of a life insurance policy constitutes ordinary income.[45]

2. Sale of Life Insurance Policy

The IRS has adopted a bifurcated approach for determining the character of gain arising out of the sale of a life insurance policy. First, the amount of ordinary income that would have been recognized if the life insurance policy were surrendered retains its character as ordinary income.[46] Then, to the extent that

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[40] Rev. Rul. 2009-13.

[41] Rev. Rul. 2009-13.

[42] I.R.C. § 1222 (emphasis added).

[43] *E.g., Bodine v. Commissioner,* 103 F.2d 982 (3d Cir. 1939); *Cobbs v. Commissioner,* 39 B.T.A. 642 (1939).

[44] Rev. Rul. 2009-13.

[45] Rev. Rul. 2009-13; Rev. Rul. 64-51. Note that although IRS has only specifically addressed taxable gains realized on surrender of a life insurance policy, the same logic should apply to losses realized on surrender of a life insurance policy. Thus, any loss realized on surrender of a life insurance policy would presumably be ordinary in character (as opposed to capital gain).

[46] Rev. Rul. 2009-13.

the sale produces gain beyond what would have been recognized upon surrender of the life insurance policy, that portion of the gain constitutes capital gain.[47]

C. Examples

The following examples illustrate the application of the rules and concepts relating to life settlement transactions discussed in Sections II.A. and II.B above.

> *Example 1.* On January 1, 2005, a 78-year-old female entered into a $435,000 universal life insurance contract. The policy is owned by a trust. In 2013, the policy was sold in a life settlement transaction for $217,500. Total premiums paid up to the date of the life settlement transaction were $109,733, and there was no cash surrender value.
>
> At the date of the life settlement transaction, the insured suffered from health issues resulting in an official life expectancy of approximately 75 months. However, she did not qualify as "terminally ill" or "chronically ill" as those terms are defined by the tax code.

In general, a trust figures its taxable income in much the same manner as an individual taxpayer.[48] Accordingly, the fact that the policy is owned by a trust should not change the basic tax analysis for determining taxable gain.

The amount realized on the sale of the life insurance policy is equal to the $217,500 received in the life settlement transaction. The tax basis in the life insurance policy equals the total premiums paid of $109,733, reduced by the cost of insurance protection consumed during the life of the policy. Since the policy had no cash surrender value, cash surrender value cannot be used as a proxy for tax basis in this case. However, COI can be estimated using actuarial tables that estimate the

[47] *Id.* Although the IRS revenue ruling does not address the character of losses arising out of the sale of a life insurance policy, there is nothing to indicate that the same bifurcated analysis should not apply in determining the character of a loss.
[48] *See* IRS Form 1041 Instructions (2012).

annual cost of term life insurance for a 78-year-old individual. Per the actuarial tables provided in IRS Notice 2002-8 (relating to split-dollar life insurance arrangements), the cost of insurance protection for a 78-year-old insured would be approximately $44.33 per $1,000 of insurance coverage. On a $435,000 policy, COI would therefore be approximately $19,284.[49] Thus, the tax basis in this life insurance policy would be approximately $90,449,[50] resulting in taxable gain of $127,051.[51] Since the policy has no cash surrender value, there would be no ordinary income recognized on surrender of the policy; therefore, the entire $127,051 gain is properly characterized as capital gain.

Since the life insurance policy is owned by a trust in this example, a question arises as to who must pay the tax associated with the life settlement transaction. The answer to this question may differ depending on the specific terms of the trust involved. However, in many cases, the insured will end up being liable for the federal income tax because the insured is usually the grantor of the trust, and most trusts are drafted to allow for the use of trust income to pay premiums on the life of the insured/grantor.[52] As a result, the Internal Revenue Code may hold the insured liable for the income tax on the life settlement proceeds.[53] Note, however, that it may be possible to draft the trust to avoid this result – *e.g.,* by requiring premiums to be paid only out of trust principal and not out of trust income.[54] The specific tax result is going to depend on the specific terms of the trust involved, and it is, therefore, impossible to articulate a general rule regarding who will ultimately be liable for the tax liability.

Example 2. A $2.5 million universal life insurance policy was issued on January 1, 2011The policy was sold for $240,000 in a life settlement

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49 [$435,000 * $44.33]

50 [$109,733 total premiums paid – $19,284 cost of insurance protection]

51 [$217,500 sale proceeds – $90,449 tax basis]

52 BNA Portfolio 807, *Life Insurance Trusts,* Section VI.

53 *See* I.R.C. § 677(a)(3).

54 BNA Portfolio 807, *Life Insurance Trusts,* Section VI.B.

transaction on May 1, 2013. As of the sale date, $105,000 in premiums had been paid in, and the policy had a cash surrender value equal to $135,000. The insured would not be considered terminally ill or chronically ill.

The amount realized on the sale of the life insurance policy is equal to the $240,000 received in the life settlement transaction. As previously discussed, current IRS guidance appears to allow the use of cash surrender value as a proxy for basis (i.e. deemed to reflect total premiums paid - cost of insurance protection absent indication to the contrary). Under that approach, a tax basis of $135,000 can be assumed, resulting in taxable gain of $115,000. The character of this gain would then be determined using a bifurcated approach. That is, the gain is ordinary income to the extent that ordinary income would have been recognized on the surrender of the policy, and any remaining gain in excess of that amount would be capital gain.

Surrender of the life insurance policy would have produced ordinary income of $30,000 [$135,000 cash surrender value - $105,000 premiums paid]. Therefore, $30,000 of the $115,000 gain should be considered ordinary income for tax purposes. The remaining $85,000 gain should be considered capital gain.

D. Charitable Bargain Sale as Alternative to Traditional Sale Transaction

A charitable bargain sale occurs when a taxpayer sells an asset for less than fair market value to a qualified charity, intending the “bargain” element as a charitable contribution. A properly structured charitable bargain sale of a life insurance policy could generate a charitable deduction for tax purposes, which would effectively offset a portion of the taxable gain triggered by the sale of the life insurance policy. In addition, a taxpayer may be able to spread the tax liability for the life settlement income over several years if the charitable bargain sale is properly structured as an installment sale where the purchase price is payable to the policy owner in installments over several years. Policy owners interested in structuring a life settlement transaction as a charitable bargain sale should consult with a tax advisor to obtain advice specifically tailored to their circumstances.

E. Note on Losses

A review of the case law reveals several cases in which loss deductions were disallowed in life insurance settlement transactions.[55] A casual reading of these cases might suggest that a taxpayer cannot claim a loss on the sale of a life insurance policy. However, such a reading would misconstrue the holdings of these cases. The holding in each of these cases was that the taxpayer incorrectly calculated basis in the life insurance policy by failing to consider the cost of insurance consumed by the insured prior to the life settlement transaction. In each of these cases, when basis was properly reduced to account for the cost of insurance consumed by the insured prior to sale of the policy, the result was taxable gain rather than loss. However, if a taxpayer can establish that the amount realized in a life settlement transaction is less than the properly calculated tax basis in the life insurance policy, then a loss deduction should be allowed. The IRS implicitly acknowledged the availability of a loss deduction in the life settlement context in Revenue Ruling 2009-13 insofar as that revenue ruling repeatedly speaks in terms of gain *or* loss when discussing the tax consequences associated with the sale or surrender of a life insurance policy. Moreover, the IRS allowed a loss deduction on the surrender of a bank-owned life insurance policy in a private letter ruling issued the same year as Revenue Ruling 2009-13.[56]

Thus, assuming that a taxpayer can establish the existence of a bona fide tax loss, a loss deduction should be allowed.[57] Note, however, that it is still necessary to determine how to claim the loss deduction on the tax return. Depending on the

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[55] *E.g., Standard Brewing Co. v. Commissioner,* 6 B.T.A. 980 (1927); *Keystone Consolidated Publishing Co. v. Commissioner,* 26 B.T.A. 1210 (1932); *Century Wood Preserving Co. v. Commissioner,* 69 F.2d 967 (3d Cir. 1934).

[56] PLR 200945032.

[57] I.R.C. § 165 allows a loss deduction for any loss sustained during the taxable year and not compensated for insurance or otherwise.

circumstances, the loss may be deductible as either an adjustment to the taxpayer's adjusted gross income ("above-the-line") or as a miscellaneous itemized deduction ("below-the-line"). The proper tax return treatment of the loss deduction will vary depending on each taxpayer's particular facts and circumstances. Taxpayers should consult a tax advisor to obtain tailored advice regarding the amount, character, and tax return presentation of a loss deduction arising out of a life insurance settlement transaction.

III. State Tax Consequences

The focus of this paper is on Federal tax consequences. However, it is important to be aware that a life settlement transaction may also carry state and local tax consequences.

Most state tax return forms use federal adjusted gross income (AGI) or federal taxable income as the computational starting point for determining state taxable income. From there, state taxable income is calculated by making various adjustments to the federal figure. Since the starting point for computing state taxable income generally comes from the federal tax return, the state tax impact will be merely indirect – that is, there will generally only be state tax consequences if there are federal tax consequences. There is considerable diversity among the fifty states in terms of state and local taxation, and potential state and local tax consequences should be independently evaluated for each state in which a taxpayer has a tax filing obligation.

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