The Taxation of Life Settlements

Steve Shorrock

IRS Rulings Raise New Issues

By Steve Shorrock, ChFC, CLTC, FLMI

On April 6, 2009, Senator Herb Kohl (D-Wisconsin), Chairperson of the Senate's Special Committee on Aging, wrote to Treasury Secretary Timothy Geithner requesting clarification of the tax treatment of transactions within the life settlement market. A month later, the Internal Revenue Service issued Revenue Rulings 2009-13 and 2009-14. These rulings "clarify" some tax issues facing seniors and investors, but leave many important questions and uncertainties unresolved. Indeed, taken together the rulings have a number of presumably unintended consequences and raise a number of entirely new issues.

Revenue Ruling 2009-13

This provides guidance to original holders of life insurance policies who surrender or sell their policies. Where an original holder of a life insurance policy surrenders that policy, the ruling confirms that the holder's taxable profit is reduced by the full amount of any premiums paid. The ruling also reiterates the long held position that any such profit is ordinary income rather than a capital gain, and that for tax purposes such a transaction cannot create a "loss."

Where the holder sells the policy to a third-party, however, the IRS confirms its somewhat controversial position (set forth in prior Private Letter Rulings) that the holder's basis is not equal to the full amount of premiums paid, but instead must be reduced by the portion of the premiums paid for the "provision of insurance" (i.e., the cost of insurance). If the policy being sold is a pure term policy (with no cash surrender value), all premiums paid are presumed to be the cost of insurance for this purpose. The ruling does finally confirm, however, that a portion of the gain can be capital in nature. In particular, the component of any gain that is represented by "inside build up" on the policy (i.e., cash surrender value less aggregate premiums paid) is ordinary income, while any gain in excess of the "inside build up" is capital gain. Because term policies do not ordinarily have an "inside build up" component, gains from the sale of term policies should qualify as capital gain in their entirety.

Unfortunately, RR 2009-13 does not clearly define the mechanism by which the reduction in basis is to be calculated or what the portion of the premium expended for "the provision of insurance" is applicable. The ruling references the "cost of insurance" (COI) charges, but these are not uniformly defined in life insurance policies, nor or they routinely reported to policy owners; in the case of a whole life policy, in fact, they cannot be determined at all. From a practical standpoint, there is no consistent method for the seller of a policy (or his tax advisors) to determine the basis in the contract and therefore what tax, if any, is due.

This ruling does resolve one open point for participants in premium finance programs. If a participant were to surrender his or her policy in full satisfaction of a non-recourse loan under such a program, such participant would presumably not get full tax basis for premiums paid, thereby increasing the potential for a taxable "phantom" gain in such scenario.

This ruling clearly creates a disparity in tax treatment between the surrender of a policy and the sale of the same policy. Upon surrender, a taxpayer will receive a full basis offset for premiums paid, but will be taxed at ordinary income rates for any proceeds in excess of that amount. Upon sale, however, he or she will not have a full basis offset, but "profits" may (in part) be taxed at capital gain rates. Depending on the facts, a taxpayer could have a better tax result upon either a sale or surrender. It is therefore incumbent upon the Advisor to make sure that a client receives proper advice as to the tax consequences of any particular transaction.

In sum, Revenue Ruling 2009-13 raised the following issues:

- Disparate treatment of surrenders vs. sales;
- The definition of "cost of insurance" charges or how they can be obtained or determined;
- The methodology for determining the adjusted basis in a contract being sold to a third party.

Revenue Ruling 2009-14

This ruling addresses (at least to some degree) the tax treatment to life settlement investors with respect to policies they have purchased. If the secondary market purchaser sells the policy (in a tertiary sale) prior to maturity, the ruling states that any gain on the sale that is not attributable to "inside build up" is capital in nature, and that the seller's basis is the purchase price plus the full amount of any premiums paid (without any reduction for the cost of insurance). If, on the other hand, the policy matures as a death claim, the ruling holds that the profits (the death benefit less the purchase price plus the premiums paid) are ordinary income rather than capital gains.

RR 2009-14 also states that any death proceeds received by a non-US secondary market purchaser (i.e., a Cayman fund classified as a corporation for US tax purposes) that is not engaged in a US trade or business constitutes US source income and is subject to withholding for US federal income tax at a rate of 30%. No guidance is provided as to whether the non-US secondary market purchaser would be subject to US tax if it had instead sold the policies in a tertiary sale. Although the 30% withholding can be reduced according to applicable tax treaties, the life insurance carrier has no way of determining either the policy owner's basis nor the appropriate withholding rate. Therefore, the carrier is likely to simply withhold 30% of the death proceeds and leave it up to the offshore owner to file for a refund.

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New 430(d) Plan Seen As Choice For Many

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other employees.)

Exhibit 2 illustrates that these new classic defined benefit plans with life insurance—430(d) plans—will likely become the plan of choice for sole proprietors, sole practitioners and business owners and practitioners who employ only family members or who have only one or two other employees. In cases that involve employees, it will be important that the employees be much younger than the owner or practitioner.

This new defined benefit plan will also appeal to full time employees of large organizations who "moonlight." The plan design is a byproduct of the pension plan funding regulation proposed by the Internal Revenue Service in December of 2007 and finalized by the Service in December of 2009. Since this plan design is so new, you can assume that most of your business owner and professional practitioner clients have not yet seen it.

The principal advantages of the 430(d) design are that it offers flexibility in plan investments, life insurance product types and funding and some contribution flexibility. To learn more about Combination Plans and how they work, contact me at gkozol@smlny.com or 800-346-7171, Extension 7304. FA

Exhibit 2: Why the New Plan of Choice

	Age	Compensation	Micro(k)	403(b) Defined Benefit	
Owner	57	$245,000	$49,000	$54,500	Minimum
				$54,500	Recommended
				$54,500	Maximum

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The facts addressed in Revenue Ruling 2009-14 are limited to pure term policies without any cash value. It is unclear whether the conclusions summarized above would differ if policies with cash value were involved. In addition, while Revenue Ruling 2009-14 does provide some guidance regarding the amount, character, and source of income to life settlement providers, the ruling unfortunately does not address other important questions, such as whether non-deductible interest expense incurred by a secondary market purchaser to purchase or carry a policy can be added to the purchaser's basis in such policy.

In addition to a lack of clarity and consistency, RR 2009-14 has the unintended effect of forcing both capital and jobs off-shore and will in practice result in a reduction of revenue to the Treasury as funds are re-positioned in countries with favorable double tax treaties.

In sum, Revenue Ruling 2009-14 raised the following issues:

- How can a policy be sold as a capital asset one day and then mature as a death claim and be taxable as ordinary income on the next?
- Treating the entire death benefits as subject to a 30% U.S. withholding tax when paid to foreign investors is a questionable (and highly inequitable) result

The Life Insurance Settlement Association (LISA) has raised these issues in several meetings with Treasury and has asked that these rulings be withdrawn or clarified. The Administration's "green book" proposals did have some settlement related proposals, and it is quite possible that legislation will be introduced to clarify some of the outstanding issues. FA

Steve Shorrock is President of LifeVentures Corp, which designs new life insurance products and develops marketing concepts for agents, and Director of Veris Settlement Partners, a life settlement firm that brokers seniors' unwanted or unneeded life insurance policies. You can reach him at his Northport, Long Island office at 631-239-6655 or steve@lifeventurescorp.com