

## Life Settlement Taxation Revisited

The life settlement market has certainly “tightened” up as a result of many economic issues but it is not dead by any means. What I would like to do in this article is to refresh our memory about the taxation of life settlements and how the results have changed under current law.

Before the IRS changed the tax rules back in 2009, the prevailing wisdom was that the taxation upon the sale of a contract would be non-taxable up to basis, ordinary income from basis to cash value and capital gains over and above cash value. For example, if the policy owner had a Universal life policy for \$1mm, paid a premium of \$10,000 for 20 yrs. and the cash value was \$300,000 and sold the policy for \$400,000 the spread between the basis of \$200,000 and \$300,000 of cash value would be taxed as ordinary income and the spread between the cash value of \$300,000 and the sale price of \$400,000 would be taxed as capital gain.

There was a pair of revenue rulings issued in May, 2009, that provided additional guidance. Revenue Ruling 2009-13 reiterated for individual policy owners that life insurance is a capital asset for tax purposes but the surrender of a policy results in ordinary income, not capital gain. Go figure!

Back to our “original” policy:

- Total premiums paid of \$200,000
- Current cash value of \$300,000
- Upon **surrender** there would be a gain of \$100,000 taxed as ordinary income
- Upon **sale** the cumulative cost of insurance must be used to reduce the basis under the current rules. Cumulative cost of insurance totaled \$50,000, therefore the adjusted basis is \$150,000.
- The policy upon sale for \$450,000 has an ordinary income gain of \$150,000 and a capital gain of \$150,000. If we assume a 40% ordinary income tax bracket and a 20% capital gain tax bracket (includes state income tax) then the after tax proceeds would be \$210,000 but the after tax proceeds of the surrender would be \$240,000!!

Based on these life settlement tax guidelines one really has to do their homework prior to recommending a sale. Based on our experience, obtaining cumulative cost of insurance charges can be difficult.

Let us know how we can help and be a better resource.