IRS Issues Guidance On Taxation of Life Settlement Transactions

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On May 1, 2009, the IRS issued a pair of Revenue Rulings addressing the tax treatment of life settlement transactions, just days after Treasury Secretary Timothy Geithner assured Congress that guidance in this area would be issued soon.

Guidance For Individual Policyholders

Life insurance contracts are capital assets but surrenders are ordinary income.

For individual policyholders, Revenue Ruling 2009-13 clarifies that life insurance contracts are "capital assets" for tax purposes, but also maintains that the surrender of a life insurance contract results in ordinary income, not capital gain. While the IRS stated no specific reason for this conclusion, it is not likely to be controversial; practitioners have generally advised that the surrender of a life policy is not a "sale or exchange" of the policy, such that one of the required elements of capital gain treatment is absent. Thus, in general, the excess of the cash surrender proceeds over the cumulative premiums paid is taxed at ordinary income rates rather than lower capital gain rates.

The IRS did state that Code section 1234A (enacted in 1981) provides no basis for a policyholder to claim capital gain treatment on surrender, another conclusion that is not likely to be controversial. (Section 1234A deals with income from the lapse or settlement of certain options and other derivatives with respect to capital assets, not a disposition of the asset itself.)

Revenue Ruling 2009-13 includes an example in which a policyholder has paid $64,000 in cumulative premiums, of which $10,000 has been consumed for cost of insurance charges imposed under the policy. The policy has cash surrender value of $78,000, reflecting that amounts credited to the policy by the company (the explicit or implicit investment return) have more than fully offset the cost of insurance charges. Upon a surrender, the policyholder in this example would be subject to tax at ordinary income rates on the net "inside build-up" in the contract, equal to $14,000 (the $78,000 cash surrender value minus $64,000 in premiums paid).

Sale of a life policy - "cost of insurance" excluded from tax basis.

The tax code's specific rules for computing income received under a life insurance contract assure that the policyholder gets full credit for premiums paid in the case of a surrender, but on a sale to a third party the IRS takes the position that these specific rules give way to the general concept of tax "basis" in an asset.

Revenue Ruling 2009-13 holds that if an individual policyholder sells a policy to a third-party purchaser rather than surrendering it to the life insurance company, the individual may not use the amounts paid for "cost of insurance" charges to increase tax basis or reduce taxable gain. When the policyholder in the example sells the policy to a third-party investor for $80,000, the policyholder's tax basis for computing gain on sale is only $54,000 ($64,000 in premiums paid less $10,000 cost of insurance). Under case law discussed in the ruling, the IRS takes the position that a portion of premiums paid represents personal consumption of life insurance protection (the cost of insurance amount) and only the remainder of the premiums paid is the cost of an asset. The gain on sale is therefore $26,000 ($80,000 minus $54,000).

The IRS position on this issue requires policyholders who sell their policies to third parties to obtain their cumulative "cost of insurance" information from the life insurance company in order to file their tax returns – information that may not be regularly provided to policyholders.

Gain is part ordinary, part capital.

Revenue Ruling 2009-13 also holds that $14,000 of the policyholder's $26,000 gain is taxable as ordinary income, because it is a substitute for the $14,000 of net inside build-up the policyholder would have received upon a surrender. Under case law discussed in the ruling, the IRS takes the position that this portion of the gain represents an accrued right to receive ordinary income, which cannot be transformed into capital gain by assignment to a third party. The remaining $12,000 of gain is treated as capital gain.

Basis in term policies.

Finally, Revenue Ruling 2009-13 holds that a policyholder's tax basis in a pure term life insurance policy having no cash value is limited to the amount of any unearned premium, absent other proof to the contrary.

Effective date.

Revenue Ruling 2009-13 indicates that the IRS positions on excluding the cost of insurance from basis, and treating a portion of gain on sale as ordinary income, will not be applied to sales occurring before August 26, 2009.

Guidance For Life Settlement Investors

On the same day, the IRS also issued Revenue Ruling 2009-14, which addresses the tax treatment of transactions involving the purchase and sale of life insurance policies by investors.

Death benefit produces ordinary income to investor.

Revenue Ruling 2009-14 confirms that where an investor buys a policy as an investment and holds it until death of the insured, the investor is taxable on an amount equal to the death benefit received minus (i) the cost to acquire the policy and (ii) the amount of premiums subsequently paid. (The ruling does not address the treatment of interest paid on a debt-financed investment in a life settlement.)

The ruling states that a life settlement policy may be a capital asset in the hands of the investor, but nonetheless concludes that the taxable portion of the death benefit is ordinary income, not capital gain, without stating a reason for this conclusion. (As noted above, many practitioners would take the view that this result is due to the lack of a "sale or exchange".)

Resale produces capital gain to investor with no haircut for "cost of insurance."

Revenue Ruling 2009-14 also addresses an investor's resale of a life settlement policy prior to death of the insured, and holds that an investor's tax basis includes, in addition to the acquisition cost, the full amount of premiums the investor pays, even though such premiums largely or entirely represent the "cost of insurance." In this welcome ruling, the IRS has acknowledged that the rationale for treating a portion of a consumer's life insurance premiums as personal consumption, rather than investment, does not extend to a life settlement investor.

In addition, the ruling concludes that an investor's gain on resale of a life settlement policy prior to death of the insured is capital gain, using an illustrative example of a 15-year term policy rather than a cash value policy. The IRS notes that these facts do not present the question (discussed above) of whether a portion of taxable gain on resale of a cash value policy should be treated as an accrued right to receive ordinary income. This issue may be of little or no importance in any case, if the life settlement investor maintains the cash values of the policies it holds at minimal levels.

Withholding tax.

Finally, Revenue Ruling 2009-14 confirms that the taxable portion of a death benefit paid to a foreign life settlement investor by a domestic life insurer on the life of a domestic insured is "U.S. source FDAP" subject to 30% withholding tax (unless the withholding tax is eliminated by treaty, an issue the ruling does not address). The ruling does not address the issue of how a domestic life insurer can determine what portion of the death benefit paid represents taxable income rather than recovery of acquisition costs and amounts subsequently paid.

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