



# **TAXATION OF LIFE INSURANCE POLICIES IN AN EVOLVING SECONDARY MARKETPLACE**

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## **Taxation of Life Insurance Policies**

***This paper provides a brief overview of the taxation associated with both traditional and evolving third party life insurance transactions. It also takes a look at the differing methods for tax basis computation endorsed by IRS and highlights the potential impact on life insurance premiums finance. There are numerous other tax regulations applicable to life insurance policies which are not addressed in this article. This paper does not provide any tax or legal advice and should not be relied upon for purposes of determining individual tax liabilities.***

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### **INTRODUCTION**

Life insurance has traditionally been treated as a static asset. Historically, the only options available for an owner of a life insurance policy were to continue maintaining the policy with premium payments, restructure the policy, or allow the policy to lapse by surrendering it back to the issuing life insurance company. Recently, however, this traditional view has been altered with the emergence of an evolving secondary market for life insurance policies. Today, seniors are now able to sell in-force life insurance policies into a viable, competitive and active secondary marketplace maintained by institutional investors – the life settlements market.

The popularity of the life settlements market has grown rapidly as these transactions have proved enormously beneficial to seniors over the historical option of allowing a policy to lapse or be surrendered. Through a life settlement, seniors (typically age 65 or older) are able to sell policies that are no longer needed, for which premiums have become burdensome or to realize an investment profit. The policies are sold at their “fair market value”<sup>1</sup> (“FMV”) for amounts substantially greater than policy cash surrender values, which FMV is determined by multiple factors such as the insured’s age, medical condition, policy performance factors and market interest rates. In a life settlement transaction, the purchaser takes the position of the policy owner, names itself the beneficiary and becomes responsible for future premium payments. By stepping into the shoes of the policy owner, the life settlement purchaser is able to acquire a valuable financial asset which has a certain payout under the life insurance contract.

In response to a growing life settlement industry, several novel and innovative estate planning techniques have emerged. One such technique, commonly known as premium financing, involves lenders willing to finance premiums of seniors seeking life insurance because the life insurance policy is viewed as a valuable financial asset. Typically the premium finance loan is

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<sup>1</sup> For in-depth reviews regarding the pricing of life settlements, see:

Dan Zollars, Scott Grossfeld & Deborah Day, *The Art of the Deal: Pricing Life Settlements*, CONTINGENCIES, January/February, 2003 at 35; and see:

Insurance Studies Institute 2008, Introduction To Methodologies Used To Price Life Insurance Policies In Life Settlement Transactions.

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provided in the form of a non-recourse or partial recourse<sup>2</sup> note which covers the premium payments for the first two to three years of the policy. There are numerous other premium financing arrangements that are recourse and/or may not involve third party financing investors.

The technique of premium financing has grown rapidly in popularity as it provides advantages to both parties involved. The senior participant typically receives two to three years of 100% financing for his/her life insurance.<sup>3</sup> Should the participant die during the loan period, his/her beneficiaries will receive a windfall death benefit minus amounts payable under the loan. If the participant survives the loan period he/she can, depending on the financing arrangement, choose to retain the policy by paying off the loan amount; sell the policy in the life settlement market to pay off the loan amount and retain any excess cash; or surrender the policy to the lender with no additional obligation if the loan was provided on a complete non-recourse basis. If the policy is retained by the senior, through either a death benefit payout or loan payoff, the lender recoups all proceeds provided under the loan plus interest and financing fees. Alternatively, if the participant sells the policy or is able to surrender the policy in satisfaction of the loan, the policy will be sold in the life settlement market.<sup>4</sup>

As a result of this rapidly evolving secondary marketplace for life insurance, the taxation of life insurance transactions and computation of a life insurance policy tax basis has become increasingly important. Yet, the proper taxation of life settlement and premium finance transactions is not entirely clear and the Internal Revenue Code ("Code") fails to provide a methodology for the proper tax basis calculation when the policy is sold to a third party.

### **Tax Implications: Death Benefit Payout**

Traditional life insurance transactions, such as death benefit payout, policy lapse and policy surrender, have been around for some time and both the Code and case law have established their proper tax treatment.<sup>5</sup>

Life insurance proceeds paid "by reason of death of the insured" to the original owner of the policy or valid transferee<sup>6</sup> are excluded from gross income calculations.<sup>7</sup> However, as a general rule, death benefit proceeds are not exempt from tax if the policy, or any interest in the policy, has been transferred to a third party by assignment or otherwise for valuable consideration and the insured does not retain an interest in the policy.<sup>8</sup> This is commonly known as the "transfer

<sup>2</sup> A non-recourse loan is one in which the lender has agreed to seek satisfaction of the debt only in the property that secures the loan, here the life insurance policy, and not in the borrower's personal assets.

<sup>3</sup> In some arrangements the participant may retain a right to some portion of the future policy market value in excess of financing obligations.

<sup>4</sup> See Understanding Life Settlements and Industry Issues Entering 2008, by Insurance Studies Institute, January 22, 2008.

<sup>5</sup> It is important to note that exchanges of policies can be subject to tax free treatment. This is another substantial subject of tax law that is not addressed in this paper.

<sup>6</sup> A transferee in this instance is someone who received the policy from the original owner for no consideration.

<sup>7</sup> I.R.C. § 101(a)(1).

<sup>8</sup> I.R.C. § 101(a)(2).

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for value” rule. All death benefits paid under the “transfer for value” rule are taxable as ordinary income to the extent the proceeds exceed the transferee’s cost basis in the policy. This “transfer for value” rule also applies to those who may have an “insurable interest” in the insured, i.e., a child, other relative or business partner. An exception to this rule is if after such transfer the final ownership is to the insured (e.g., to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer).<sup>9</sup> Under this exception, the death benefit proceeds are not included in taxable income to the recipients of the death benefits.

The significance of these rules is that when investors in the secondary insurance markets purchase all or a portion of a life insurance policy in which the insured does not retain an interest, subsequent distributed death benefits are taxable income to the investor to the extent such proceeds exceed their cost basis, unless the resultant transaction resides in an entity in which the insured is a shareholder or partner. The “transfer for value” rule has not been widely understood because most taxpayers understand life insurance death benefits to be non-reportable income and insurers are not required to issue an IRS 1099 form on such payments. Even after a policy has been transferred to an investor, there is no clear practice of insurers issuing an IRS 1099 to beneficiaries when death benefits are paid, leaving large taxable amounts potentially not reported as taxable income.

### **Tax Implications: Policy Lapse and Policy Surrender**

If a policy owner allows an insurance policy to lapse, the owner cannot claim a deductible loss against other income for any basis that remains in the lapsed policy. Any basis remaining in the policy will be treated as part of the cost of the insurance policy for tax purposes and permanently lost to the taxpayer.<sup>10</sup>

If instead the policy owner surrenders the policy for its cash surrender value, the proceeds the owner receives will not have been paid by reason of death of the insured, so the gross income exclusion described in the preceding section will not apply. Thus, cash surrender amounts received will be taxed as income to the policy owner. The Code does, however, provide a special benefit in that the proceeds received are taxable only to the extent that they exceed the total aggregate of premiums paid, including any interest paid on related loans if such interest was not otherwise deducted by the taxpayer.<sup>11</sup> By including the premium payments in the tax basis calculation, the Code in effect makes premium payments deductible up to the cash surrender value that are otherwise non-deductible in a lapsed policy. However, to the extent the premiums exceed the cash surrender proceeds, such excess premiums or tax basis are lost and not available for deduction against other taxable income.

<sup>9</sup> IRC § 101(a)(2)(B); Treas. Reg. 1.101-1(b).

<sup>10</sup> London Shoe v. Comm’r, 80 F.2d 230, 232 (2nd Cir. 1935), Century Wood Preserving Co. v. Comm’r, 69 F.2d 967, 968 (3rd Cir. 1934).

<sup>11</sup> See I.R.C. § 72(e)(6); Treas. Reg. § 1.72-11(d)(1).

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Income received from a surrendered policy in excess of the tax basis is taxed at ordinary income rates and not at capital gain rates.<sup>12</sup> Congress provided the preferential capital gains treatment in an effort to mitigate the lock-in effect caused by grouping the total appreciation of an asset into a single taxable year.<sup>13</sup> For an asset to qualify for capital gains treatment it must be held for the requisite period (an asset held for more than 12 months qualifies for long-term capital gain treatment<sup>14</sup>), transferred under a qualifying “sale or exchange”,<sup>15</sup> and not specifically excluded from capital gains definition under the Code.<sup>16</sup>

On first examination, one might view the payments received from the surrendered policy as capital in nature.<sup>17</sup> After all, the policy would have been held for more than one year and life insurance policies are not specifically excluded under the Code’s capital asset definition. However, case law suggests that the surrendering of a life policy does not meet the sale or exchange requirement to be a valid capital gain sales transaction.<sup>18</sup>

Another position is that the surrendering of a policy may qualify an asset for capital gains treatment because the Code considers contract terminations to be a qualifying capital asset sale.<sup>19</sup> Despite these positions, capital gain treatment is inappropriate for a life policy that is surrendered regardless of whether the sale or exchange requirement is met. Several cases have concluded that any gain recognized on the difference between the cash surrender value and tax basis of the policy is to be treated as ordinary income under the “accretion to the value of a capital asset” concept.<sup>20</sup> A critical issue outlined by the courts is whether the gains recognized upon disposition of the policy can properly be attributed to an appreciation in the value of the capital asset itself rather than accretions to the value of a capital asset properly attributable to ordinary income.<sup>21</sup> In instances where the taxpayer's gain is *not* attributable to an appreciating asset but rather to predictable rates of interest earned on the asset, ordinary income results. Because cash surrender values are attributable to premium accumulations in excess of the policy

<sup>12</sup> Gain inherent in an asset is not generally taxable as income until the gain has been realized by the taxpayer. Thus, even though an asset may appreciate over a number of years, the gain from the appreciation will not be taxed until the asset is sold or exchanged. Unlike ordinary income, which is fully taxed in the year in which the realization event occurred, capital gains are taxed over a period of years and are therefore generally preferred by taxpayers.

<sup>13</sup> See *Comm'r v. Gillette Motor Transp., Inc.*, 364 U.S. 130, 134 (1960) (indicating the purpose of Congress affording capital gains treatment was to ameliorate the hardship of realizing the entire appreciation of an asset in one taxable year); see also *Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260, 265 (1958) (stating that Congress was concerned that taxpayers could be deterred from making an otherwise desired sale absent the preferential rate).

<sup>14</sup> I.R.C. § 1222(3).

<sup>15</sup> See I.R.C. § 1222.

<sup>16</sup> See I.R.C. § 1221(a)(1-8).

<sup>17</sup> See *Comm'r v. Phillips*, 275 F.2d 33, 36 (4th Cir. 1960) (indicating that a policy sold in excess of the cash surrender value, perhaps due to a decline in health of the insured, may be characterized as a capital asset); see also Tech. Adv. Mem. 200452033 (Sept. 27, 2004) (stating that a life insurance policy may qualify for capital asset characterization).

<sup>18</sup> *Bodine v. Comm'r*, 103 F.2d 982, 987 (3rd Cir. 1939).

<sup>19</sup> See I.R.C. § 1234A(1); see also Tech. Adv. Mem. 200452033 (Sept. 27, 2004) (stating that life insurance policy surrender may qualify as a valid capital asset sale or exchange under I.R.C. § 1234A(1)).

<sup>20</sup> *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965).

<sup>21</sup> *Midland-Ross Corp.*, 381 U.S. at 57 (1965); *Crocker v. Comm'r*, 37 T.C. 605, 610 (1962); *Roff v. Comm'r*, 36 T.C. 818, 824 (1961).

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costs and to rates of interest earned on the accumulated account value rather than an increase in the value of the capital asset itself, gains recognized between the tax basis of the policy and its cash surrender value are treated as ordinary income.

### **Tax Implications: Life Settlement Contract**

If the policy owner sells a policy in the secondary life settlement market where sales prices are determined by criteria affecting the market worth of the policy itself rather than cash surrender value any realized gain up to the amount of the policy's cash surrender value is taxed as ordinary income. However, the tax treatment of gains realized above the cash surrender value has not been clearly resolved by IRS. Such gains should presumably be treated as capital gains. Here long-term capital gains treatment seems appropriate as the policy has been owned for more than 12 months and sold to a third party in the life settlement marketplace. In the sale of a policy to the secondary market, the sales price is determined by criteria such as the insured's age and medical condition, the policy performance factors and financial market influences including market interest rates, which represent the appreciation in the value of the asset itself and not upon interest earned under the life insurance contract. However, IRS points out in a technical advice memorandum that even though a life insurance contract may be treated as a capital asset, the entire gain from the sale of a contract should be treated as ordinary income.<sup>22</sup>

The point remains unclear. Based on existing IRS Code, IRS regulations and case law, gains realized from the sale of life insurance policies in the secondary market should be bifurcated.<sup>23</sup> The amount by which the cash surrender exceeds the policy's tax basis should be treated as ordinary income.<sup>24</sup> Any proceeds realized between the life settlement amount and the cash surrender value should be treated as a capital gain.<sup>25</sup> If the policy has no cash surrender value, or if the cash surrender value is lower than the policy's tax basis, then the entire difference between the proceeds realized from a life settlement and the policy's tax basis should be treated as a capital gain. However, until the Internal Revenue Service provides clear guidelines on these new and evolving transactions, taxpayers should rely upon their tax advisor to determine how they report life settlement gains.

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<sup>22</sup> I.R.S. Tech. Adv. Mem. 200452033

<sup>23</sup> See *Bolnick v. Comm'r*, 44 T.C. 245, 253-57 (1965) (applying a bifurcated ordinary income/capital gain tax treatment in a similar context).

<sup>24</sup> For example, suppose a taxpayer sold a policy under a life settlement contract that had a tax basis of \$100,000, cash surrender value of \$200,000, and life settlement sales price of \$300,000. The difference between the tax basis and cash surrender value in the policy (\$200,000 - \$100,000) would be treated as ordinary income as this gain is primarily attributable to predictable rates of interest earned under the life insurance contract.

<sup>25</sup> Any remaining gain (\$300,000 - \$200,000) above the cash surrender value (or tax basis if greater than the policy's cash surrender value) will be treated as capital gain.

**Tax Implications: Premium Finance**

Participants in a partial and complete non-recourse premium financing arrangement have four potential outcomes under the contract:

- a) There is a mortality event with death benefit payout during the financing term. As stated previously, death benefit payouts to the original policy owner and beneficiaries are received tax free.<sup>26</sup> However, if law determines that the structure of the premium financing transaction voids the owner's insurable interest in the policy, then the death benefit proceeds, if paid by the insurer, would be taxable as ordinary income.
- b) The policy owner elects to retain the policy through the repayment of the premium finance loan. If the policy is retained, there is no taxable event to the policy owner and the loan payment and interest thereon become part of the owner's tax basis in the policy unless the interest was otherwise deductible.
- c) The policy owner elects to sell the policy in the secondary market. See Tax Implications: Life Settlement Contract above for the proper tax treatment of policy sales.
- d) The policy owner elects to forfeit the policy to the premium finance lender in full satisfaction of the premium finance loan. The policy owner will be subject to a taxable event in an amount equal to the difference between the loan amount and the tax basis in the policy.<sup>27</sup>

In case (d) above, a transfer of the policy to the lender in exchange for full satisfaction of the loan results in taxable gain. But IRS Code, Regulations and guidelines are not clear as to how this gain is taxed.

IRS Code requires the amount of cancellation of debt ("COD") to be added to gross taxable income<sup>28</sup> (but in the case of an insolvent taxpayer, such COD may be excluded from gross taxable income); however, exchange of an asset as settlement of debt may or may not result in taxable gain depending on the market value of the asset and the nature of the debt. According to case law<sup>29</sup> and IRS regulations,<sup>30</sup> a distinction is made between recourse and non-recourse debt for taxation purposes.

In the case of recourse debt, the amount by which the settled debt exceeds the exchanged asset's fair market value ("FMV") at the time of transfer is treated as COD income, and the amount by which the FMV exceeds the tax basis is treated as taxable gain.<sup>31 32</sup> In such an exchange, the FMV would not be expected to be greater than the amount of settled debt.

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<sup>26</sup> I.R.C. § 101(a)(1).

<sup>27</sup> See I.R.C. § 1001; Treas. Reg. § 1.1001-2.

<sup>28</sup> See I.R.C. Section 61(a)(12)

<sup>29</sup> See *Commissioner v. Tufts*, 456 U.S. 960 (1982).

<sup>30</sup> See Treas. Reg. § 1.1001-2(a)(2).

<sup>31</sup> Treas. Reg. § 1.1001-2(c), ex. 8.

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However, in the case of non-recourse debt the entire difference between the amount of the debt discharged and the taxpayer's basis in the asset is treated as taxable gain and not COD regardless of the asset's FMV.<sup>33</sup> Therefore, a senior who obtains total non-recourse premium financing and relinquishes the policy in full satisfaction of the loan amount will recognize taxable gain equal to the difference between the settled debt amount and the tax basis of the policy at the time the policy is transferred to the lender. However, the question remains: How is the non-COD gain taxed?

The tax complexities increase as premium financing moves into hybrid structures where the debt assumed is partially recourse and partially non-recourse. These arrangements are growing in popularity although the Code does not directly address their proper tax treatment.

The position taken by the IRS is that payment relating to partial recourse debt is allocated first to the non-recourse portion of the debt unless an agreement to the contrary has been made between the debtor and creditor, and that the resulting tax treatment should be consistent with state law.<sup>34</sup> According to this ruling, a taxpayer transferring a life insurance policy to settle the non-recourse debt, along with cash to settle the recourse debt, if required, to a lender in satisfaction of a loan that is both non-recourse and recourse may have either of the following tax consequences depending on the FMV of the policy transferred.<sup>35</sup>

- a) If the sum of cash and FMV of the life insurance policy transferred to the lender is ***less than*** the non-recourse portion of the debt, the taxpayer recognizes taxable gain measured by the difference between the non-recourse portion of the debt and the sum of the cash and tax basis of the policy transferred, with COD income recognized to the extent that the total settled debt exceeds the non-recourse portion.
- b) If the sum of cash and FMV of the life insurance policy transferred to the lender is ***equal to or greater than*** the non-recourse portion of the debt, the taxpayer recognizes taxable gain measured by the difference between the FMV of the policy and its tax basis, with COD income recognized to the extent the sum of the total settled debt, both recourse and non-recourse, exceeds the sum of cash and FMV value of the policy transferred.

Typically IRS will look to available market valuations of the transferred policy to determine its FMV; however, where such valuation is not available, and it is reasonable to expect that none would be available when a policy is forfeited for settlement of debt, the fact that the lender accepts the policy as full satisfaction of both the non-recourse and recourse debt establishes the argument that the value of the policy equals the settled debt.

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<sup>32</sup> For example, suppose an asset has a tax basis of \$200, a fair market value of \$300 and the creditor discharged a loan of \$500 in return for the surrendering of the asset. The difference between the basis and fair market value (300-200) will be gain and the amount above the fair market value (500-300) will be COD income.

<sup>33</sup> Treas. Reg. § 1.1001-2(c), ex. 7.

<sup>34</sup> I.R.S. Tech. Adv. Mem. 8348001 (Aug. 18, 1983)

<sup>35</sup> Tax Aspects of Restructuring Financially Troubled Businesses, BNA Tax Management Portfolios, TMFEDPORT No. s 541 II (Sept. 2007).

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While there are no clear case law decisions or guidelines by the IRS on this subject, it should be expected that any non-COD gain recognized by the policy owner upon transfer of the policy to the lender in satisfaction of the note will be treated as ordinary income and not capital gains. Despite the fact that surrendering a policy to a lender may otherwise meet the capital gain sale or exchange requirements,<sup>36</sup> there is no evidence the value of the policy transferred to the lender resulted from anything more than accretion of premiums paid and interest earned.

If the loan is completely non-recourse, the borrower is under no obligation to repay.<sup>37</sup> In essence, a senior borrower in a complete non-recourse premium finance transaction is compensated by receiving the benefit of life insurance during the loan term.<sup>38</sup> The lender, on the other hand, provides this compensation to the policy owner as an incentive for the potential of acquiring a valuable investment which could not have been acquired without the senior's participation. This fact becomes another argument in determining the taxable nature of the gain, i.e., when the taxpayer transfers the policy to the lender, the debt in excess of the policy tax basis represents the value of the life insurance provided to the senior. Thus, such gain recognized should properly be treated as ordinary taxable income.

In some premium finance structures, the lender will loan an amount to the participant that is greater than the premiums due during the term of the note. The presence of such additional loan amounts does not alter the tax consequences whether the loan is partially or completely non-recourse. The policy owner's taxable income, COD or gain, is determined using the full amount of the loan satisfaction, including the additional compensation. Note that additional loan amounts are not added to the policy tax basis and become taxable income when the loan is settled. However, other upfront considerations, if any, paid or transferred to the policy owner at inception of a premium financing arrangement, may be taxable at that time.

### **Policy Tax Basis Calculation**

This tax discussion would not be complete without an inquiry into the proper tax basis calculation of a life insurance policy. Generally, an asset's tax basis has a direct effect on the amount of gain or loss an individual recognizes in a taxable transaction.<sup>39</sup> A higher tax basis translates into smaller taxable gain and larger taxable loss deduction and is therefore desired by taxpayers for tax purposes. Tax basis is meant to reflect the investment a taxpayer has in an asset and generally equals the aggregate of purchase price plus capitalized additions, less total

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<sup>36</sup> I.R.C. § 1234A(1).

<sup>37</sup> It should be noted that, depending on the reasonable expectation of repayment, a non-recourse loan may still qualify for split-dollar loan tax treatment. See I.R.C. § 1.7872-15 for a review of the rules relating the split-dollar loan tax treatment.

<sup>38</sup> See Sutter v. Comm'r, 76 T.C. Memo (CCH) 59 (1998) (calling for ordinary income treatment in a similar non-recourse premium financing arrangement); See also Mitchell M. Gans & Jay A. Soled, A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference, 7 Fla. Tax Rev. 569, 618 (2006) (arguing in favor of ordinary income treatment for non-recourse premium financing arrangements).

<sup>39</sup> I.R.C. § 1001(a), I.R.C. § 1012.

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depreciation.<sup>40</sup> Thus, while in most transactions the tax basis calculation is relatively straightforward, the law regarding the proper tax basis calculation of life insurance policies is unsettled.

The IRS Code mandates that the tax basis of a life insurance policy surrendered to the issuing insurance company shall be the aggregate of premiums paid under the policy.<sup>41</sup> However, the appropriate methodology for determining tax basis upon policy sale in a life settlement or surrender to a premium finance lender has not been settled by IRS. Nevertheless, it seems logical that an analogous tax basis calculation would be used for these parallel life policy transactions. In fact, both case law<sup>42</sup> and initial IRS published guidance<sup>43</sup> support just such a tax basis approach.

However, after initially adhering to this formula, the IRS has begun to argue in Private Letter Rulings<sup>44</sup> that the proper tax basis calculation for life insurance policy sales should not include the portion of the premium attributable to the cost of insurance. While Private Letter Rulings may not be relied upon as valid precedent,<sup>45</sup> these written determinations of the IRS should be noted as they may signal a future tax policy shift that could have a substantial effect on the life settlement industry and seniors considering life settlements and/or obtaining premium finance loans.

The IRS first deviated from its initial published guidance in Private Letter Ruling No. 9443020.<sup>46</sup> This Private Letter Ruling dealt with the tax treatment of a life insurance policy sold by a taxpayer afflicted with AIDS to a viatical settlement company. The only difference between viatical and life settlements is that viatical settlements deal exclusively with insured individuals who are deemed either terminally<sup>47</sup> or chronically<sup>48</sup> ill. The Code states that taxpayers participating in a qualifying viatical settlement will receive the same income tax free treatment as if payment was received by reason of death under I.R.C. § 101(a).<sup>49</sup> Absent this Code section, however, policies sold to a third party under a viatical settlement contract would receive tax treatment equal to those transferred under a life settlement transaction. This suggests the reasoning applied in PLR

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<sup>40</sup> For example, if the purchase price of an asset is \$20,000, the \$20,000 paid represents the taxpayer's investment and thus the asset's initial tax basis. The taxpayer will only recognize gain on amounts received above the \$20,000 tax basis upon transfer of the asset.

<sup>41</sup> I.R.C. § 72(e).

<sup>42</sup> See *Phillips v. Comm'r*, 275 F. 2d 33 (4th Cir. 1960)

<sup>43</sup> See Rev. Ruling 70-38 (1970)(holding that no gain is produced if the sales price of the policy does not exceed the aggregate amount of premiums paid).

<sup>44</sup> Private Letter Rulings are issued by the IRS in response to individual taxpayer requests for rulings regarding specific tax situations.

<sup>45</sup> See I.R.C. § 6110(k)(3) (provides that a written determination, such as a Private Letter Ruling may not be used or cited as precedent in other cases).

<sup>46</sup> I.R.S. Priv. Ltr. Rul. 9443020 (Jul. 22, 1994).

<sup>47</sup> I.R.C. § 101(g)(2)(B)(ii).

<sup>48</sup> I.R.C. § 101(g)(2)(B)(iii).

<sup>49</sup> I.R.C. § 101 (g).

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9443020 may be of particular importance for the tax basis treatment of life settlements and premium financed policies as it was written prior to the enactment of I.R.C. § 101 (g).<sup>50</sup>

In PLR 9443020, the IRS relied on both Code sections<sup>51</sup> and case law<sup>52</sup> to declare that the taxpayer's basis in the policy was equal "to the premiums paid less the sum of (i) the cost-of-insurance protection provided through the date of sale and (ii) any amounts (e.g., dividends) received under the contract that have not been included in gross income."<sup>53</sup> Since issuing Private Letter Ruling 9443020, the IRS has continued to argue in favor of reducing the tax basis calculation by the cost of insurance,<sup>54</sup> however, it has stopped short of formally overturning its prior published guidance.

The importance of the issue of tax basis methodology to participants in the life settlement marketplace is best understood if illustrated. Consider the following example: A taxpayer purchases a \$1 million universal life insurance policy. The annual premium associated with maintaining the policy is \$50,000 and the cash surrender value grows \$20,000 each year. After two years, the policy owner would have paid \$100,000 in premiums and the policy would have a cash surrender value of \$40,000. If the taxpayer were to surrender this policy to the insurance company for the cash surrender value, the \$100,000 of premiums payments would be used to determine the policy's tax basis<sup>55</sup> and the taxpayer would receive the entire \$40,000 cash surrender payout tax free. And if a similar tax basis calculation were used for a taxpayer surrendering a policy under a completely non-recourse premium financing arrangement, the taxpayer would recognize no taxable gain as the \$100,000 premium finance note<sup>56</sup> discharged by the policy's surrender to the lender would not exceed the tax basis of the policy.

However, a taxpayer surrendering a policy with a tax basis reduced by the cost of insurance would face a very different result. According to the IRS guidance, the cost of insurance reduction is calculated by "the difference between (i) the aggregate amount of premiums paid and (ii) the cash value of the contract with regard to surrender charges."<sup>57</sup> Under such a scenario, a taxpayer surrendering the same policy would recognize \$60,000 of taxable gain.<sup>58</sup> As demonstrated by this

<sup>50</sup> The IRS has concluded under I.R.C. § 101 (g) that a viatical settlement payment is effectively a death benefit paid early and should therefore be treated as such. However, absent this provision, a taxpayer receiving payment under a viatical settlement would be similarly situated to a taxpayer receiving payment under a life settlement as both individuals would be selling their policy for valuable consideration to a third party. As such, prior to the enactment of I.R.C. § 101 (g), both individuals would theoretically receive similar tax treatment.

<sup>51</sup> Treas. Reg. § 1011, 1012, and 1016.

<sup>52</sup> London Shoe v. Comm'r, 80 F.2d 230 (2nd Cir. 1935), Century Wood Preserving Co. v. Comm'r, 69 F.2d 967 (3rd Cir. 1934).

<sup>53</sup> I.R.S. Priv. Ltr. Rul. 9443020 (Jul. 22, 1994).

<sup>54</sup> See I.R.S. C.C.A. 200504001 (Oct. 12, 2004).

<sup>55</sup> I.R.C. § 72(e).

<sup>56</sup> The premium financing note would equal two years of premium payments (2 x \$50,000).

<sup>57</sup> I.R.S. Priv. Ltr. Rul. 9443020 (Jul. 22, 1994).

<sup>58</sup> The cost of insurance would equal the difference between the aggregate of premiums paid and the cash surrender value (\$50,000 - \$20,000 = \$30,000 (cost of insurance protection)). Reducing the aggregate of premiums paid by the cost of insurance (2 x (\$50,000 - \$20,000)) would provide a tax basis in the policy of \$60,000.

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example, whether a senior should obtain a premium finance loan could hinge on how the IRS calculates the policy's tax basis in the future. But further, understanding that IRS established this argument in a viatical settlement case with no premium financing, there is concern that IRS may attempt to apply this argument to the cost basis of all policies, including surrender to the carrier and in life settlement transactions. Such application could have material negative impact on both the insurance industry and the life settlement industry.

### **Conclusion**

The traditional options of policy lapse or surrender are no longer the only alternatives available for disposing of an unwanted life insurance policy. An active secondary market has emerged in which institutional investors are purchasing life insurance policies from seniors for amounts often many times greater than: (i) the cash surrender values of the policy, and (ii) the premiums paid. The result is new substantial tax revenues to federal and state governments. In 2007, Conning Research & Consulting, Inc. reported in its Strategic Study Series on the Life Settlement Market that transactions in 2006 approximated \$6.1 billion, and that by 2016 the annual transactions could reach \$140 billion.<sup>59</sup> Clearly, the issue of taxable income and tax revenues is substantial.

In direct response to the growing life settlement industry, several innovative estate planning techniques such as premium financing have emerged. Even as premium finance transactions are being scrutinized by insurance carriers, life settlement firms, investors, regulators and legislators, third party sale of life insurance policies is becoming more common and the tax community needs to focus its attention on the unfolding questions concerning the proper computation of gain and tax basis for sellers of life insurance policies.

While taxation of death benefit payouts, policy lapse and policy surrender to carriers have been well settled, the IRS has yet to provide formal guidance on the subject of policy sales under life settlement. Argument for reducing cost basis by the cost of insurance conceivably opens well settled basis calculation of policies surrendered to carriers. Existing case law suggests that a bifurcated approach for the sale proceeds of a life settlement is the proper tax treatment, even if the policy was premium financed. Under such an approach, gains recognized between the tax basis and the cash surrender value in the policy would be deemed ordinary income, and gains recognized above the cash surrender value (or, if the policy has no cash surrender value, above the tax basis of the policy) would be given capital gains treatment. In the matter of complete non-recourse premium finance, the transfer of a policy to a lender in discharge of the note constitutes gain and not COD income. Any gain recognized through the discharge of a non-recourse premium finance loan should be treated as ordinary taxable income as no part of the loan debt represents an increase in the market value of the policy.

The Code is not clear on the proper tax basis calculation for policies sold as life settlements in the secondary market. In its guidance, the IRS has provided conflicting views, having applied an approach similar to that mandated under the Code for policy surrenders and calculated basis by

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<sup>59</sup> Life Settlement Market Increasing Capital and Investor Demand 2007, by Conning Research & Consulting, Inc.

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the aggregate of premiums paid. However, while not formally overruling this approach, the IRS has in private letter rulings argued for an approach under which a policy's basis is reduced by the cost of insurance. Under the IRS private letter ruling approach, one who sells a policy or surrenders a policy in satisfaction of a premium finance loan would be accountable for taxation on the portion of the debt balance discharged that exceeds the aggregate of premiums paid reduced by the cost of insurance. Again, the IRS argument of reducing policy tax basis by the cost of insurance conceivably opens well settled basis calculation methodologies of policies surrendered to carriers. It must be asked as to why would the reduction of a policy tax basis by the cost of insurance differ depending on the transaction used to exit the policy? Why should the tax basis of a life insurance policy be forcibly reduced by cost of insurance any more than the tax basis of real estate or equipment be forcibly reduced by depreciation that has not otherwise been expensed against taxable income?

There remain numerous unanswered questions concerning the taxation of life insurance policies within the evolving secondary insurance marketplace. It is without question, however, that this multi-billion dollar marketplace represents an important revenue source that continues to grow for federal and state governments. It is therefore vital that the IRS provide clarification through future tax regulations so that the resulting tax revenues are efficiently accessed at both the federal and state levels.