



Tax Aspects of Life Settlement Arrangements

By: Randy Gardner, JD, LLM, MBA, CPA, CFP®, Julie Welch, MS, CPA, CFP®, and Neil Covert, JD



Every day 30,000 people turn 65. Over 85% of universal life insurance policies and over 95% of term life insurance policies do not end up in a death benefit getting paid. Life settlement arrangements allow a policy owner over age 65 who no longer needs the insurance coverage to get cash out of a policy in excess of the cash surrender value.

Life insurance is a tax-advantaged product. Generally if the policy holder dies, the policy holder's estate or heirs may have to pay estate tax, but a beneficiary, such as a family member or significant other named by the policy holder, receives the life insurance proceeds free of income tax. This income tax exclusion is lost if the policy is transferred for value to a third party beneficiary, such as an investor or life settlement provider. The life settlement provider will pay income tax on the difference between the face value of the policy and the sum of the purchase price and premiums paid, unless the life settlement provider qualifies as a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. If the life settlement provider is in the trade of business of buying insurance policies (the typical case), the gain is ordinary income.

Despite the harsh tax treatment for the life settlement provider when the insured dies, many policy holders are obtaining cash for their policies prior to death by selling them to life settlement providers. Based on industry statistics, the average life settlement candidate is a 78 year-old male who owns a universal life insurance policy valued at \$1.8 million, and the average lump sum payment typically ranges from 2 to 5 times the policy's cash surrender value. In addition to universal life insurance

policies, most other types of life insurance policies may qualify for a life settlement, including variable universal life (VUL); term policies (if convertible); whole life; and group policies (if portable and convertible).

Example: John, age 78, is in the 33% marginal federal and 7% marginal state income tax brackets and is the owner/insured of a life insurance policy with a \$1,000,000 face value. John paid premiums of \$120,000 over a 40-year period. The policy has a cash surrender value of \$200,000, meaning John has potential gain of \$80,000 (\$200,000 – 120,000) in the policy. John approached the insurance company that issued the policy, hoping to obtain more than \$200,000 from the surrender. His request for a larger lump sum was denied, and he was informed he would pay income tax at ordinary tax rates of \$32,000 (\$80,000 x 40%) on the \$80,000 gain. John ends up with cash of \$168,000 (\$200,000 – 32,000) after paying income tax.

A life settlement provider offered John \$523,000 (\$1,000,000, discounted for John's 8-year life expectancy at 8% with an adjustment for 8 years of \$3,000 premiums). As shown in the illustration and assuming a 15% federal capital gain tax rate and 7% state income tax rate, John will pay \$103,060 (\$323,000 (15% + 7%) + 80,000 (33% + 7%)) of income tax on his life settlement, leaving John with cash of \$419,940 (\$523,000 – 103,060) after paying income tax.

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Tax Level 3: The amount John receives in excess of the cash surrender value (\$323,000) is presumably taxed as capital gain (*Jules Reingold*, BTA Memo 1941-319). The *Reingold* decision held that life insurance was a capital asset in the right circumstances, but the age of the decision and dissimilarity to life settlement fact patterns leaves life settlement candidates with some uncertainty.

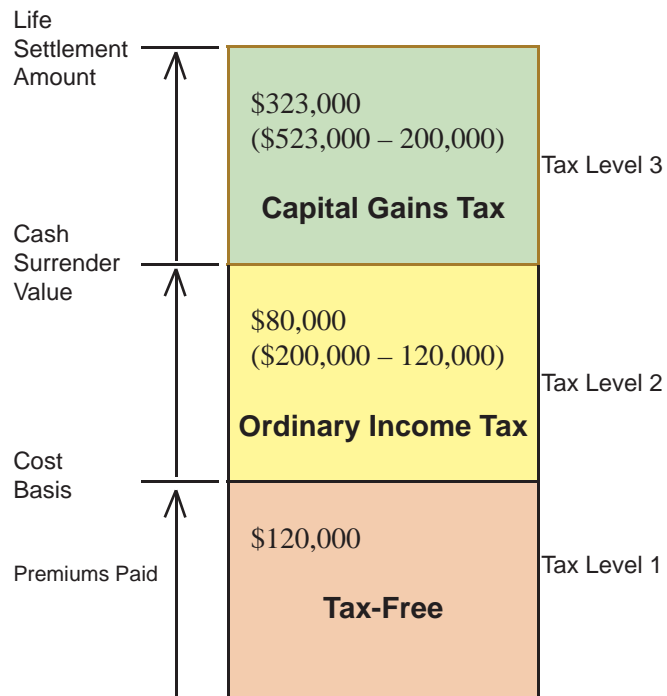
Tax Level 2: The amount John receives over his adjusted cost basis up to the cash surrender value (\$80,000) is taxed at ordinary income tax rates (*Percy Phillips* (CCA-4, 1960) and *Edwin Gallun* (CCA-7, 1964)).

Tax Level 1: The amount John receives up to his adjusted cost basis (\$120,000) is not subject to income or capital gain tax. John's adjusted cost basis is generally the amount of premiums he paid to date, less certain costs and dividends not included in income (IRC Section 72(e)(6)). The IRS has taken the controversial position that premiums attributable to the cost of insurance should not increase basis (CCA 200504001 and PLR 9443020).

There are numerous reasons seniors choose life settlements. Some of the more common scenarios are: (1) the insured's estate tax burden has decreased and thus the insured no longer needs liquidity to pay estate taxes; (2) the insured wants cash for personal use or to give to his or her family or favorite charity; (3) the insured can no longer afford the policy or plans to surrender it; (4) the policy is a key-person policy and no longer needed by a retiring executive; and (5) the insured needs funds for medical or long-term care.

Life Settlements for VUL Policies Are Securities Transactions

Although universal life insurance policies comprise the bulk of life settlement transactions, Variable Universal Life (VUL) policies – particularly those with investments in subaccounts that have not performed according to market expectations – may be prime candidates for settlement in the secondary market. In August 2006, NASD issued Notice to Members 06-38 addressing member obligations with respect to the sale of existing VUL policies to third party investors operating in the secondary market for life insurance. This notice remind-



ed us that, according to the NASD, the sale of a VUL policy is a securities transaction subject to applicable NASD rules.

The elements of Notice 06-38 directly impacting the handling of VUL life settlement transactions concern:

1. Establishing the client's suitability for the product;
2. Conducting due diligence;
3. Performing "best execution" by soliciting bids from multiple licensed providers;
4. Establishing written procedures involving product training and supervision; and
5. Prohibiting the payment of compensation on a transaction except by another member firm (broker-dealer).

Some broker-dealers have taken the position that although they will not proactively promote or advertise the product, they are putting procedures in place to make the option available to their registered representatives in situations where a life settlement may be the most suitable solution for the client. Following the issuance of NASD Notice 06-38, many independent broker-dealers began screening life settlement brokers and establishing preferred vendor relationships to service this business from their registered reps.

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Alternatives for Obtaining Cash from a Life Insurance Policy

Transaction	Advantages	Disadvantages	Tax Treatment
Surrender the policy	Guaranteed source of cash. Fewer administrative obstacles than selling or exchanging the policy.	Give up life insurance protection. Many policy holders obtain more cash from selling the policy.	Ordinary income tax rates apply to the difference between the cash surrender value and the policy holder's basis in the policy.
Sell the policy	Many policy holders obtain more cash from selling the policy than from surrendering the policy to the insurer	No guarantee that a purchaser will acquire your policy. Give up life insurance protection. Hidden transaction costs.	Presumably capital gain tax rates apply to the difference between the sale price and the cash surrender value. Ordinary income tax rates apply to the difference between the cash surrender value and the policy holder's basis in the policy. A sale by a terminally ill insured to a viatical provider may be tax free.
Take accelerated death benefits or sell your policy to a viatical provider	Payments may be tax free if the insured is terminally or chronically ill.	Death benefits are reduced. Difficult to qualify. Most insurance companies require a rider on an existing policy.	Payments may be tax free if the insured is terminally or chronically ill.
Borrow against the policy	Guaranteed source of cash. Not a true debtor/creditor transaction. Generally tax free distribution. Retain life insurance protection.	Nondeductible personal interest expense. Reduction of death benefit.	Tax free if policy does not lapse when the loan balance exceeds the cash surrender value.
Exchange the policy	Allows policy holder to convert to a life insurance or annuity contract that is more economical and better suited to needs.	Section 1035 requirements must be satisfied.	Tax free if executed properly.

Life Settlement Alternatives

Although life settlements are becoming more popular, there are alternatives that may be more appealing to clients depending on their situation.

Viatical settlements. If the client is terminally or chronically ill, death benefits received by the policy holder prior to death from the life insurance contract may be tax free (IRC Section 101(g)). The payments may come

from the insurer or a viatical settlement provider. A client is terminally ill if a physician has certified that the client has an illness or physical condition that reasonably can be expected to result in death within 24 months. A client is chronically ill if a licensed health care practitioner certifies that the client needs substantial assistance performing at least two activities of daily living (eating, toileting, transferring, bathing, dressing, and continence). For a chronically ill individual, the accelerated benefits are limited to out-of-pocket costs for long-term care services.

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Life insurance policy loans. For cash-value life insurance contracts other than modified endowment contracts, a policy holder may be able to arrange a loan from the insurer. Typically these distributions are tax free, and the interest due on the policy loan is nondeductible. If the policy lapses when the loan amounts received exceed the adjusted premiums paid, then gain in the contract is taxed at ordinary income rates. Losses from a life insurance contract are personal and nondeductible unless the contract was entered into for profit (Section 165).

Tax-free exchanges of life insurance and annuity contracts. Under IRC Section 1035, no gain or loss is recognized from the exchange of a life insurance policy for an annuity or different life insurance policy. This provision allows policy holders to exchange existing policies for insurance contracts that are more affordable or better suited to their needs. Starting in 2010, the cash value from annuities and life insurance contracts can be used to acquire long-term care insurance without the premium payment being treated as a taxable distribution. If the policy holder is seeking long-term care insurance and currently holds a policy that does not qualify for this treatment, a Section 1035 exchange may be the solution.

Conclusion

Client's needs change over time. Clients with life insurance policies that no longer serve a purpose have many choices, including surrendering, selling, viaticating, borrowing from, or exchanging the policy.

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Note: This article is an expansion of a planning strategy included in the 2009 book WealthCounsel® Estate Planning Strategies.