Robin & Peter on LIFE SETTLEMENTS

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Clarity for Life Settlement Taxation Falls Off the "Cliff"

When the IRS issued its long awaited Revenue Ruling 2009-13 in May of 2009, it clarified a number of questions regarding the taxation of life settlements to non-investor sellers like your clients. But the ruling's lack of clarity and novel approach also raised almost as many new questions as it answered.

As a result, Senate Bill S 2048 was introduced by Senator Robert Casey (D-PA) to clarify many of those issues. However, in the chaos to get a tax bill passed to avoid the "fiscal cliff," Senator Casey's bill fell by the wayside. While it is expected that the bill will be reintroduced this year, for now, Revenue Ruling 2009-13 is still in control.

The basis for a policy that is surrendered is the cumulative premiums (less any withdrawals, surrenders, or dividends taken in cash). The IRS ruled, however, that the basis for a policy sold by a non-investor is cumulative premiums minus cumulative cost of insurance (COI) charges. This distinction is just plain bad tax law for a variety of reasons:

- There has never been any need or requirement for insurers to keep track of these charges. As a result, the cumulative COI charges are frequently not available. What's a seller to do?
- What are the COI charges for a whole life policy? What about a policy that has been 1035 exchanged?
- Subtracting the COI charges from the cumulative premiums could produce a negative number. Is it possible for a policy to have a negative basis?
- Why should a senior who sells a policy be in a potentially worse tax position than one who surrenders a policy? What purpose does such tax policy serve? Although, generally, the additional proceeds of a life settlement should offset the

additional taxes, there are situations where it will not. In those situations, the rulings have created a lose/lose situation. The seller loses by getting less for their policy and the government loses tax revenue because the policy is surrendered, rather than sold for a higher amount, which would often generate some additional tax revenue.

- Another hidden danger is that this ruling does not distinguish between life settlements and non-life settlement transfers or sales. So a business that sells or bonuses a policy to a key employee at retirement, or business partners or shareholders, that transfer policies to each other, could be forced to recognize significant additional taxable income.

As long as we have to live with this ruling, prior to closing a life settlement transaction, the client should be instructed to request the cumulative COI charges from the insurance company. They should not wait until after the transaction closes because the insurer may be unwilling to deal with them once they are no longer listed as the owner of the policy.

As situations come up, don't let your senior clients lapse or surrender a policy without investigating the possibility of a life settlement. Remember, it always pays to ask, so don't hesitate to give us a call.

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