



## IRS Issues Rulings on the Taxation of Life Settlements

For several years, the life insurance industry has needed and called for a more substantial federal framework for understanding the tax implications of a sale of an in force life insurance policy to third-party investors who intend to profit at the death of the insured (life settlement transaction). On May 1, 2009, the IRS issued Revenue Rulings 2009-13 and 2009-14 addressing the amount of income subject to tax on the sale of a life insurance policy and on the payment of the death benefit. The rulings also address the tax character of the income (i.e., whether it is ordinary income or capital gain).

### IRS Revenue Ruling 2009-13: Taxing the Seller of the Policy

In this ruling, the IRS detailed the income tax consequences for insureds who sell policies. The ruling provides three examples and discusses the tax results of each.

**Example I: Surrender of a Policy.** In this scenario, the policyholder, who is also **the insured, surrenders a cash value policy.** The IRS ruled that the difference between the cash surrender value (CSV) and the "investment in the contract" (generally premiums paid) would be **taxed as ordinary income.** The IRS referenced IRC § 72(e), which expressly governs the taxation of amounts received on the complete surrender of a life insurance contract. Section 72 provides that any amount received on the complete surrender of a life insurance contract is includible in income to the extent that it exceeds the owner's investment in the contract. The Code defines an "owner's investment in the contract" as the premiums or other consideration paid for the contract, minus all amounts received under the contract to the extent otherwise excludable from income. The IRS illustrated this rules using the following example:

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|--|-----------------|
| (1) Cash Surrender Value   | \$78,000        |
| (2) Less "Investment in the Contract"<br>(Generally Premiums Paid) | -64,000         |
| <b>(3) Equals Gain Taxed As Ordinary Income</b>                    | <b>\$14,000</b> |

**Example II. The Sale of a Cash Value Policy.** The facts in this scenario are the same as those in Example I, except that the **insured sold the contract** for \$80,000 to an unrelated third party. The IRS noted that the tax rules in IRC § 72(e), which are applicable to amounts "received under a contract on its complete surrender, redemption or maturity" had no bearing on the determination of the basis of a life insurance contract that is sold. Rather, the IRS applied the general income tax rules provided in IRC § 1011 for determining gain. Under this analysis, the policy was treated as a capital asset with **part of the amount realized receiving capital gain treatment and part taxed as ordinary income.**

The IRS found that the insured had a taxable gain on the sale equal to the amount received as the sales price (the amount realized) minus his/her adjusted basis in the insurance contract. The IRS defined the insured's adjusted basis as premiums paid less any expenditure, receipts, losses, or other items properly chargeable to a capital account, and less the cost of the pure insurance protection earned and used during the insured's period of ownership of the policy.

The IRS then said that the gain was partially ordinary income as well as capital gain because of the “substitute for ordinary income doctrine.” This doctrine converts capital gain into ordinary income where the asset sold is itself properly attributable to income. The result, ordinary income is limited to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., the inside build-up in the contract).

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|--|-----------------|
| (1) Basis (Premiums Paid)                | \$64,000        |
| (2) Less Cost of Insurance               | -10,000         |
| <b>(3) Adjusted Basis</b>                | <b>\$54,000</b> |
| (4) Sales Proceeds                       | \$80,000        |
| (5) Less Adjusted Basis (3)              | -54,000         |
| <b>(6) Gain</b>                          | <b>\$26,000</b> |
| (7) Cash Surrender Value                 | \$78,000        |
| (8) Less Premiums Paid                   | -64,000         |
| <b>(9) Ordinary Income Portion</b>       | <b>\$14,000</b> |
| <b>(10) Capital Gain Portion (6 – 9)</b> | <b>\$12,000</b> |

**Example III: The Sale of a Term Policy.** Mirroring the facts used previously, the final example involved the **sale of a level premium fifteen-year term life insurance contract with no cash surrender value.** The insured sold the policy to an unrelated party for \$20,000 on June 15<sup>th</sup> in the eighth year after paying 90 monthly premiums of \$500 for a total of \$45,000 in premiums.

Absent other proof, the cost of insurance provided to the insured each month was presumed to equal the monthly payment under the contract, or \$500. Hence on the date of the sale, the adjusted basis in the contract on the date of the sale was \$250 (i.e., the unexpired portion of the most recent premium). Finally, the IRS found that the insured realized \$20,000 on the sale, and that the gain from the sale would be taxed as **long-term capital gain.**

|                             |                 |
|-----------------------------|-----------------|
| (1) Basis (Premiums Paid)   | \$45,000        |
| (2) Less Cost of Insurance  | -44,750         |
| <b>(3) Adjusted Basis</b>   | <b>\$ 250</b>   |
| (4) Sales Proceeds          | \$20,000        |
| (5) Less Adjusted Basis (3) | - 250           |
| <b>(6) Capital Gain</b>     | <b>\$19,750</b> |

*Note: Revenue rulings are generally retroactive unless the IRS indicates otherwise. Revenue Ruling 2009-13 states that the holdings in the second and third sections of this ruling will not be applied adversely to sales occurring prior to August 26, 2008.*

### **IRS Revenue Ruling 2009-14: Taxing the Buyer of the Policy**

In this ruling, the IRS detailed the income tax consequences to life settlement companies or others that buy a policy and receive the benefits when the insured dies, or resells the policy to another company or individual. Unlike Revenue Ruling 2009-13, this ruling applies retroactively. The ruling provides three examples and discusses the tax results of each.

**Example I: Insured Dies, Buyer Collects the Death Benefit Proceeds.** In this example, the insured sold the life insurance policy to a U.S taxpayer for \$20,000 on June 15, 2008. The policy was a fifteen-year term policy with no cash surrender value. The buyer had no insurable interest in the purchased policy and had bought it solely to profit at the insured's death. The insured had been paying a monthly premium of \$500 due on the first of each month and the buyer continued to pay the required premiums to keep the policy in force. On December 31, 2009, the date of the insured's death, the buyer had paid in total \$9,000 of additional premiums and collected \$100,000 in death benefits.

The IRS concluded that the death benefit proceeds were to be included in income because the policy was acquired in a "transfer-for-value" and none of the safe harbor exceptions to the rule applied. Under the "transfer-for-value" rule, the death benefit proceeds received are taxable less the consideration paid to buy the policy and the premiums and other amounts subsequently paid by the buyer.

The IRS held that the buyer's gain was ordinary income, because the receipt of the death benefit proceeds was not a "sale or exchange" of a capital asset qualifying for capital gains treatment.

|   |                  |
|---|------------------|
| (1) Death Benefit Proceeds                          | \$ 100,000       |
| (2) Less Premiums Paid by Buyer                     | – 9,000          |
| (3) Less Price Paid to Insured                      | – 20,000         |
| <b>(4) Buyer's Taxable Amount (Ordinary Income)</b> | <b>\$ 71,000</b> |

**Example II. Resale of a Policy by the First Buyer.** The second example mirrors the facts in Example I, except that on December 31, 2009, while the insured was still living, the buyer (B) sold the policy for \$30,000 to a person or investor group (C) unrelated to the insured.

The IRS said that the sale of the policy resulted in a \$1,000 capital gain to B because B had realized \$30,000 on the sale and had an adjusted basis in the policy of \$29,000. The adjusted basis included the sum of the premiums paid by the buyer (\$9,000) and the amount paid to the insured (\$20,000).

B's gain on the resale is capital gain because the policy was held as a capital asset and the gain was realized on a sale or exchange and held for the requisite period of time.

|  |                 |
|--|-----------------|
| (1) Sales Proceeds/ Amount Realized              | \$ 30,000       |
| (2) Less Premiums Paid by Buyer                  | – 9,000         |
| (3) Less Price Paid to Insured                   | – 20,000        |
| <b>(4) Buyer's Taxable Amount (Capital Gain)</b> | <b>\$ 1,000</b> |

Note that unlike situation II in Revenue Ruling 2009-13, in this ruling the IRS did not reduce premiums paid by the cost of insurance to arrive at basis. In arriving at this conclusion, the IRS stressed that B was unrelated to the insured and bought the policy solely with the view to profit and not benefit from its coverage.

**Example III: Sale of a Policy by a Foreign Life Settlement Company.** The final example outlined in Revenue Ruling 2009-14, mirrored the facts in Example I, except that the buyer was a foreign corporation not engaged in a trade or business within the United States.

Using the reasoning found in Example I, the IRS stated that the buyer would have to recognize \$71,000 of ordinary income on the receipt of the \$100,000 death benefit. In addition, the buyer would be subject to U.S. income tax, as this income was “fixed or determinable annual or periodical income” and should be regarded as U.S source income.

The IRS stressed that the insured was a U.S. citizen residing in the United States and that the insurer was a domestic corporation.

## **In Summary**

The issuance of Revenue Rulings 2009-13 and 2009-14 address many of the income tax consequences of transactions in the life settlement market.

Prior to these rulings, parties to life settlement transactions argued that the insured-seller’s basis in the contract would be based on the aggregate premiums paid without reduction for cost of insurance charges, and that little gain would be recognized on the sale. With Revenue Ruling 2009-13, we have a ruling that requires a reduction in basis for cost of insurance when the sale is by a party with an insurable interest in the insured. As a consequence, gain to the seller is increased and a life settlement now comes with a greater tax cost. Further adding to tax cost, is the methodology found in this ruling that splits the gain upon sale for value after August 26, 2009, between ordinary income and capital gain.

These rulings will not only affect the life insurance settlement market but the life insurance industry as a whole, as insurance carriers will be placed in a position of needing to provide historic cost of insurance charges to compute gain upon a sale of the policy. The open issue raised by the rulings is how the cost of current life insurance protection is calculated.

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