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The IRS Issues Important Guidance on Life Settlement Transactions

The Internal Revenue Service (“IRS”) issued two Revenue Rulings on May 1, 2009, addressing certain tax aspects of sales and surrenders of life insurance policies: Rev. Rul. 2009-13 and Rev. Rul. 2009-14. These rulings resolve some longstanding questions regarding sales of life insurance policies and in many respects are consistent with life settlement industry expectations. Unanswered questions still remain.

What do these Rulings Say?

Rev. Rul. 2009-13

Rev. Rul. 2009-13 addresses a U.S. individual (“A”) who owns a life insurance policy issued by a U.S. life insurance company on his or her life. Rev. Rul. 2009-13 posits three situations and addresses how the amount of gain is measured in each of these situations and what its character is:

- (1) The policy is a cash value policy and A surrenders it for its cash value.

Holding. A is taxable on the gain realized under Section 72(e) of Internal Revenue Code (the “Code”). The amount of the gain equals the cash value proceeds received less the premiums paid to date (assuming there have been no previous withdrawals or distributions from the policy). The cost of insurance charges incurred to date under the policy is *not* taken into account in measuring the gain.

The gain is taxed as ordinary income

- (2) The policy is a cash value policy and A sells the policy for an amount in excess of its cash value.

Holding. A is taxable on the gain from the sale under Section 1001 of the Code. The amount of the gain equals the sales proceeds less A’s adjusted basis in the policy. A’s adjusted basis in the policy equals the premiums paid to date for the policy (assuming no there have been no previous withdrawals or distributions from the policy) *minus the cost of insurance charges incurred under the policy.*

To the extent the cash value of the policy exceeded premiums paid to date at the time of the sale (the “inside buildup”), the gain is taxed as ordinary income. *To the extent the gain exceeds this latter amount it is capital gain.*

- (3) The policy is a term life insurance policy with no cash value and A sells it for cash.

Holding. A is taxable on the gain from the sale under Section 1001 of the Code. The amount of the gain is equal to the sales proceeds less A’s adjusted basis in the policy. A’s adjusted basis in the policy equals the premiums paid to date for the policy (assuming no there have been no previous withdrawals or distributions from the policy) *minus the cost of insurance charges incurred under the policy to date.*

Since the policy has no cash surrender value, *the entire amount of gain is taxable as capital gain.*

Rev. Rul. 2009-14

Rev. Rul. 2009-14 addresses a life settlement transaction in which A sells a life insurance policy to an unrelated person (“B”) who has no insurable interest in A. Rev. Rul. 2009-14 focuses on the tax consequences of the sale to B.

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Rev. Rul. 2009-14 also posits three situations and addresses how the amount of gain is measured and what is its character, and in Situation (6) it addresses whether the death benefit is U.S. source income:

(4) B buys a term life policy with no cash surrender value from A and continues to pay premiums on the policy. Subsequently, A dies and B receives the death benefit.

Holding. The sale of the policy is a “transfer for value” under Section 101(a)(2) of the Code. B is taxable on the death benefit to the extent it exceeds the amount B paid for the policy plus any subsequent premiums B paid under the policy.

The taxable amount of the death benefit is taxable as ordinary income.

(5) B buys a term life policy with no cash surrender value from A and continues to pay premiums on the policy. Subsequently, while A is alive, B resells the policy to another person.

Holding. B is taxable on the gain from the sale under Section 1001 of the Code. The amount of the gain is equal to the sales proceeds less B’s adjusted basis in the policy. B’s adjusted basis in the policy equals the purchase price paid for the policy plus the premiums subsequently paid for the policy by B. *Significantly, B is not required to reduce its adjusted basis by any cost of insurance charges incurred under the policy.*

The entire amount of gain is taxable as capital gain.

(6) B is a foreign corporation that is not engaged in a U.S. trade or business. B buys a term life policy with no cash surrender value from A and continues to pay premiums on the policy. Subsequently, A dies and B receives the death benefit.

Holding. The sale of the policy is a “transfer for value” under Section 101(a)(2) of the Code. B is taxable on the death benefit to the extent it exceeds the amount B paid for the policy plus any subsequent premiums B paid under the policy.

The death benefit is treated as U.S. source income, notwithstanding the provisions of Section 865.

Effective Date Considerations Relating to Rev. Rul. 2009-13

The holdings of Rev. Rul. 2009-13 in Situations (2) and (3) above will not be applied adversely to sales of policies that occur before August 26, 2009. This apparently means that for sales that occur prior to this date the IRS will not assert that A’s tax basis in the policy must be reduced by cost of insurance charges. This also apparently means that until this date the IRS will not assert that the gain A realized on the sale is ordinary, rather than capital, gain.

The holdings in Situations (1), (4), (5), and (6) are effective now as statements of current law.

Key Points

These revenue rulings provide important guidance to the life settlement industry.

In general, they confirm many of the positions that people have taken in this area. However, these rulings also reject other positions that some have advanced in this area.

- A life settlement investor is not required to reduce the tax basis of a purchased policy by cost of insurance charges, but the initial purchaser is required to do so. The distinction between the two thus becomes critical.
- Gain on the sale of a policy that has no cash surrender value is capital gain (and for a cash value policy, gain is capital gain to the extent it exceeds the “inside buildup” at the time of sale).
- Taxable death benefits generate ordinary income, not capital gain. The IRS thus rejects arguments for capital gain treatment based on Section 1234A.
- Death benefits paid to a foreign life settlement investor by a U.S. life insurer are U.S. source income and thereby potentially subject to U.S. withholding taxes. Although Rev. Rul. 2009-14 cites Section 865, it does not explain why death benefits should be treated as non-U.S. source income under that Section. Thus, there remain lingering questions about how Section 865 applies.
- The rulings do not address a situation involving a loss from the sale of a policy. Presumably the measurement and character of a loss would be determined consistent with the principles of these rulings.

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The IRS Issues Important Guidance on Life Settlement Transactions (cont'd.)

- The rulings do not address interest expense deductions incurred by a life settlement investor that are disallowed under Section 264.
- Consumers contemplating selling their life insurance policy should consider acting quickly before the August 26, 2009 effective date.

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Kirk Van Brunt is a partner at LLB&L. He focuses his practice on the taxation of financial institutions and products, with a particular focus on insurance companies and insurance products. Within the insurance arena, Mr. Van Brunt has substantial experience with bank/corporate owned life insurance (BOLI/COLI) and is very active within the structured settlement industry. Mr. Van Brunt also has substantial experience in the tax treatment of asset-backed securities (especially tax issues relating to REMICs) and derivative financial instruments.