



THOMSON REUTERS

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## NEWS RELEASE

FOR IMMEDIATE RELEASE

### Understanding the Tax Costs of Life Settlements

*Thomson Reuters Analyst Explains Tax Consequences of these Secondary Insurance Market Transactions*

**New York, NY, June 1, 2009** – Until recently, individuals who no longer needed a life insurance policy had few options. In general, they could surrender the policy to the issuing insurance company for its cash surrender value or they could stop paying the premiums and let the policy lapse. For a term insurance or other policy without cash surrender value, the only choice was to let the policy lapse. Now, for some individuals, there is a secondary insurance market in which they may be able to sell a policy for more than its cash surrender value or even sell a policy without cash surrender value, such as a term policy. These transactions are called life settlements.

William E. Massey, Senior Tax Analyst for the Tax & Accounting business of Thomson Reuters, notes that the IRS recently lifted some of the uncertainty surrounding life settlements by explaining their tax consequences. “This is important for anyone contemplating a life settlement because they will now be in a position to gauge how much they will be left with after tax once they reach an agreement on the settlement amount and fees,” says Massey.

*Reason for selling.* There are a number of different reasons why one may consider a life settlement, says Massey. In these troubled times, some individuals simply can no longer afford the premiums. Others may need the funds for some worthwhile purpose. In some cases, the coverage is no longer needed, such as where the primary beneficiary has died or divorced the insured, or a business has been dissolved. The coverage may have been purchased with the intention of using the proceeds to pay death tax costs. “With decreased asset values and the higher federal death tax exemption that is now in force, this need may no longer exist,” advises Massey.

*Factors bearing on the settlement amount.* The settlement amount will depend on the unique circumstances of the specific case. Factors bearing on the amount that may be realized include the insured's age, gender, health, life expectancy, type of policy, its face amount, and any cash value.



## Understanding Tax Costs of Life Settlements

Page 2 of 3

June 1, 2009

There may be fees and commissions and state law may impose a cap on the amount that may be realized.

*Tax treatment.* Recently issued IRS guidance explains the tax treatment of policyholder surrenders and sales of life insurance contracts with and without cash value. Understanding how the IRS treats a surrender is crucial to understanding how it treats sales. The following examples illustrate the various treatments:

*Surrender.* On January 1, year one, Andy entered into a "life insurance contract" with cash value. On June 15 of year eight, Andy surrendered the contract for its \$78,000 cash surrender value, which reflected the subtraction of \$10,000 of "cost-of-insurance" charges collected by the issuer for periods ending on or before the surrender of the contract. Through that date, Andy had paid total premiums of \$64,000. According to the IRS, Andy has ordinary income of \$14,000 (\$78,000 minus \$64,000 investment in the contract). Thus, if he were in the 25% bracket, the surrender would trigger a tax of \$3,500 and Andy would be left with \$74,500 (\$78,000 minus \$3,500).

*Sale of policy with cash value.* The facts are the same as above, except that on June 15 of year eight, Andy sold the life insurance contract for \$80,000 to an unrelated entity. Here, Andy has a gain of \$26,000 because the \$10,000 cost of insurance protection reduces his basis for the premiums paid from \$64,000 to \$54,000. Of this \$26,000, \$14,000 is ordinary income and \$12,000 is capital gain. Thus, Andy would pay \$3,500 in tax on the ordinary income and \$1,800 in tax on the capital gain (15% of \$12,000). As a result, he would be left with \$74,700 (\$80,000 minus \$5,300).

*Sale of policy without cash value.* The facts are the same as in the case of the surrender, except that the contract was a level premium 15-year term life insurance contract without cash surrender value. The monthly premium for the contract was \$500. Through June 15 of year eight, Andy paid premiums totaling \$45,000. On June 15 of year eight, he sold the life insurance contract for \$20,000 to an unrelated person. In this case, the amount realized from the sale of the term life insurance contract is the sum of money received from the sale, or \$20,000. The IRS says that Andy's adjusted basis is equal to the total premiums paid, less charges for the provision of insurance before the sale. Absent other proof, the cost of the insurance provided to Andy each month is presumed to equal the monthly premium under the contract, or \$500. The cost of the insurance protection provided to Andy during the 89.5 month period that he held the contract was \$500 times 89.5 months, or \$44,750. Thus, his adjusted basis in the contract on the date of the sale was \$250 (\$45,000 total premiums paid, less \$44,750 cost of insurance protection). Accordingly, he must recognize \$19,750 on the sale (the excess of the \$20,000 amount realized on the sale over the \$250 adjusted basis). The \$19,750 is long-term capital gain. The tax on this gain is \$2,962.50 (15% of \$19,750) and he is left with \$17,037.50 (\$20,000 minus \$2,962.50).

Without further explanation, the IRS says that the conclusions regarding the sales will not be applied adversely to sales occurring before Aug. 26, 2009. Massey notes that "this may provide an opportunity to claim a higher basis, resulting in a lower tax, for sales occurring before that date."



**THOMSON REUTERS**

**Understanding Tax Costs of Life Settlements**

Page 3 of 3

June 1, 2009

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