Federal Tax Framework For Life Settlement Transactions

Historical Reference

The option to sell a life insurance policy became possible after a 1911 U.S. Supreme Court Ruling in Grigsby v. Russell deemed life insurance personal property with transferable value.

In the early 2000s, as life settlements began to gain traction as a planning tool, the IRS remained uncertain about how to tax these transactions. The first revenue ruling (Rev. Rul. 2009-13) treated a policy sale different than a policy surrender and required a calculation that deducted the cost of insurance (COI) from the cost basis (the policyowners' total investment in the asset), making it difficult for practitioners to calculate taxes.

Tax Cuts and Jobs Act 2017 (TCJA)

The TCJA clarified that a policyowner's basis is not reduced by the cumulative cost of insurance charges to determine gain on a policy sale. This change results in a higher basis and a reduction in tax liability, making the outcome more favorable to policy sellers.

Revenue Ruling 2020-05

Further updates in January 2020 made the tax treatment of selling a life insurance policy consistent with that of surrendering a policy.

Today's Three-Tier Tax Structure

NOT TAXABLE	ORDINARY INCOME	LONG-TERM CAPITAL GAIN
Cost Basis - the total amount paid into the policy. If the life settlement offer does not exceed basis, it is not taxable.	The difference between the policy's cash surrender value (if greater than cost basis) and cost basis	The life settlement offer minus cost basis + ordinary income *A capital loss occurs if the policy is sold for less than cost basis. Losses can be used to lower taxable income.

This is provided for informational and educational purposes only and is not intended to constitute tax, legal, accounting, investment, or financial advice. The tax treatment of life settlement transactions depends on the specific facts and circumstances of each case and is subject to change under applicable law. Policyowners and advisors should consult with qualified tax and legal experts regarding any life settlement transaction and before making any tax-related decisions.

Ashar does not provide tax advice. Please speak with your tax professional for more information.

© 2026 Ashar Group

LIFE SETTLEMENT

Tax Treatment in Practice

**For illustration purposes only*



Case Details

A significant premium increase from $49K to $65K is forcing the client to consider surrendering the policy. They have also had a decline in health and need to find a way to fund caregiving needs.

- Male, Age 88
- $1M Universal Life
- Cash Surrender Value (CSV): $90,000
- Cost Basis: $450,000
- Life Settlement Offer: $250,000

27 offers on life settlement policy auction platform

Outcome

Eliminated Premium Obligation

When a policy is sold, the purchaser becomes responsible for future premiums.

Funded Medical and Caregiving Needs

Received $160,000 more than they would have if they surrendered the policy.

Resolved Financial Burden

Reallocated premium and additional liquidity allowed them to fund care.

POLICY SALE RESULTED IN 55% RETURN OF PREMIUM

Tax Calculation

STEP ONE: Calculate Cost Basis = $450,000

Cost Basis = Total Policy Investment (including premiums paid), which is $450,000. This means up to $450,000 of the sale price will not be taxed.

STEP TWO: Calculate Tax Liability = $0

Ordinary Income = CSV minus Cost Basis. In this case, the cash surrender value is not greater than the cost basis, resulting in no ordinary income tax.

Long-Term Capital Gain = Sale Price minus (Cost Basis + Ordinary Income). The sale price did not exceed the cost basis, resulting in no capital gains tax.

This case resulted in a capital loss, which may reduce overall taxable income.

© 2026 Ashar Group

LIFE SETTLEMENT

Tax Treatment in Practice

**For illustration purposes only*



Case Details

The policy was purchased for estate tax planning. As the insured aged and estate tax exposure diminished, the policy was no longer needed, and the client was considering surrender.

- Female, Age 90
- $1M Guaranteed Universal Life
- Cash Surrender Value (CSV): $180,000
- Cost Basis: $175,000
- Life Settlement Offer: $240,000

32 offers on life settlement policy auction platform

Outcome

Eliminated Premium Obligation

Removed the obligation to fund coverage that no longer aligned with planning objectives.

Enhanced Planning Flexibility

Received $60,000 more than if the policy had been surrendered.

Established G2 Relationships

The additional liquidity enabled her to fund a new policy for her healthy adult grandchild.

NEW OPPORTUNITIES CREATED WITH THE NEXT GENERATION

Tax Calculation

STEP ONE: Calculate Cost Basis = $175,000

Cost Basis = Total Policy Investment (including premiums paid), which is $175,000. This means up to $175,000 of the sale price will not be taxed.

STEP TWO: Calculate Tax Liability = $5,000 Ordinary Income, $60,000 Long-Term Capital Gain

Ordinary Income = CSV minus Cost Basis. $180,000 - $175,000 = $5,000 in ordinary income.

Long-Term Capital Gain = Sale Price minus (Basis + Ordinary Income). Sale price of $240,000 - $180,000 = $60,000 in capital gains.

Actual tax liability depends on the policyowner's marginal tax bracket and capital gains rate.

© 2026 Ashar Group

LIFE SETTLEMENT

Tax Treatment in Practice

**For illustration purposes only*



Case Details

A convertible term policy was purchased for key-person coverage. As retirement approached, the need diminished and the policy was nearing the conversion deadline.

- Male, Age 72
- $750K Convertible Term
- Cash Surrender Value (CSV): $0
- Cost Basis: $60,000
- Life Settlement Offer: $110,000

19 offers on life settlement policy auction platform

Outcome

Eliminated Premium Obligation

Eliminated the need to convert to a higher-cost permanent policy.

Unlocked Hidden Value

Received 6-figures from a policy that otherwise had no cash value.

Strengthened Retirement Liquidity

Reallocated proceeds toward income planning and healthcare reserves in retirement.

CONVERTIBLE TERM POLICIES CAN QUALIFY FOR A BUYOUT

Tax Calculation

STEP ONE: Calculate Cost Basis = $60,000

Cost Basis = Total Policy Investment (including premiums paid), which is $60,000. This means up to $60,000 of the sale price will not be taxed.

STEP TWO: Calculate Tax Liability = $50,000 Long-Term Capital Gain

Ordinary Income = CSV minus Cost Basis. There is no cash surrender value, resulting in no ordinary income.

Long-Term Capital Gain = Sale Price minus (Basis + Ordinary Income). Sale price of $110,000 - Cost Basis of $60,000 = $50,000 in capital gain.

Actual tax liability depends on the policyowner's marginal tax bracket and capital gains rate.

Additional considerations may apply for C corporations, S corporations, and partnership-owned policies.

© 2026 Ashar Group