

## 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### Historical Reference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.<br><br>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<br><br>*A capital loss occurs if the policy is sold for less than cost basis. Losses can be used to lower taxable income. |

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