Federal Taxation of Life Settlement Proceeds: A Question of Gain (CC 07-09)

The life settlement industry has a consensus position, easily discovered by Googling "life settlement" or "viatical settlement" and "capital gain." Any amount of the settlement up to the adjusted basis in the policy represents a recovery of basis and is therefore tax free. Any amount up to the cash surrender value (in excess of the adjusted basis) is taxed as ordinary income. And any amount over the cash surrender value is taxed as capital gain. Take a simple example in which the death benefit is $1 million, the taxpayer`s basis is $100,000, the cash surrender value is $350,000, and the settlement provider offers a 75% payment, or $750,000. Then on the industry`s view, the tax treatment of the transaction looks like this:

	Dollar Amount	Tax Rate
Death Benefit	$1 million	N/A
Life Settlement Amount	$350,000-$750,000	Capital Gain
Cash Surrender Value	$100,000-$350,000	Ordinary
Basis	$0-$100,000	No Tax

Some of these settlement provider websites state flatly that this is the proper tax treatment of a life settlement; others offer only a modest qualification, with a de rigueur warning that one should consult a tax professional.

It`s completely understandable that the industry would take the capital gain position. But is it right? It emerges that the question is open. There are no direct authorities for a position either way on the tax treatment of that portion of a life settlement over the cash surrender value (the "Surplus"). There are arguments on both sides, but the silence of the authorities means that no argument can be conclusive.

The Arguments

Given the growth of the industry, the controversy surrounding it, and the importance of the question, the absence of an answer is surprising. The IRS has offered no guidance, and Congress enacted no statute, addressing the tax treatment of the Surplus. The IRS has issued only one private letter ruling on viatical settlements, and as the subsequent discussion shows, it is silent on the issue—yet an argument from silence should not be underestimated.

The Silence of the Letter: LTR 9443020

To see just how little there is to go on, it is worth beginning with LTR 9443020 (July 22, 1994), the only instance in which the IRS has specifically addressed questions about the tax treatment of viatical or life settlement proceeds. [I.R.C. §101(g) was subsequently added to the Internal Revenue Code by the Health Insurance Portability and Accountability Act of 1996 (HIPAA)]. The taxpayer was terminally ill with AIDS and viaticated his whole life contract for 63 percent of its face value. The ruling began by holding that an "assignment of a life insurance contract for consideration constitutes a sale of property" whose tax status is to be determined under I.R.C. §1001. Starting from that premise, the analysis was straightforward. Under §1001(b), the taxable gain is the amount realized less the adjusted basis of the contract. In this instance, "the amount realized by Taxpayer upon the sale of his life insurance contract is the consideration received from the viatical settlement company. The adjusted basis of Taxpayer`s contract is equal to the premiums paid less the sum of (i) the cost of insurance protection provided through the date of sale and (ii) any amounts (e.g., dividends) received under the contract that have not been included in gross income." [It is noteworthy that clause (i) takes the novel and essentially

unsupported position that mortality charges may not be included in basis -- at least for purposes of computing gain under §1001(a). For additional details see: Should the Basis of a Life Contract Be Adjusted by Mortality Charges? IRS Internal Legal Memorandum Says Yes (CC 05-06).]

The problem in applying LTR 9443020 to the capital gain issue is obvious. The letter ruling tells us that taxable gain results from a viatical settlement, but it is completely silent about the rate at which that gain is to be taxed. It does not even give us a basis to extrapolate to an argument either way. Some viatical settlement marketers claim that because the Service relied on §1001, the viaticated policy can generally be treated as a capital asset and anything over the adjusted basis taxed at capital gain rates. But see: TAM 200452033 which makes the point (in a different context) that gain realized on a capital asset is not automatically capital gain.

The letter ruling concludes that "the amount received by Taxpayer from Company Y, to the extent that the amount exceeds Taxpayer`s adjusted basis of his contract, is includable in Taxpayer`s gross income," without distinguishing between surrender value and the Surplus. And one could argue from this that it implicitly accords the same tax treatment to amounts up to surrender value and Surplus. That would seem to be particularly forceful since this is a case in which there probably was a Surplus. Although the ruling, like all private letter rulings, does not cite amounts, it`s reasonable to assume that the 63 percent the taxpayer received was greater than his surrender value—else why bother to viaticate in the first place? In the world of judicial proceedings, where facts must be set on the record for the sake of appeal, we would know whether this assumption is true and whether LTR 9443020 applies to the capital gain issue. In the world of the IRS private rulings, where facts are blacked out and letter rulings are not precedent, we do not.

The letter ruling holds that all of the gain from a pre-§101(g) viatication is to be included in gross income. It does not say whether or not all of the income thus included is to be taxed as ordinary income. Nor does it provide an argument either way.

Framing the Issue

What can be said in light of the silence of the letter ruling? To begin, note that there is no issue about the treatment of the proceeds up to the cash surrender value. Everybody agrees, under I.R.C. §1001(a) and LTR 9443020, that the taxpayer`s adjusted basis is to be deducted from the amount realized on the sale to arrive at the gain; it is therefore essentially excluded from taxation, as it should be. Everybody also agrees, following LTR 9443020 and a series of cases such as Gallun v. Comm`r, 327 F.2d 809 (7th Cir. 1964) and Comm`r v. Phillips, 275 F.2d 33 (4th Cir. 1960), and again LTR 9443020, that the proceeds up to the cash surrender value should be taxed as ordinary income. (If a life policy is actually surrendered, nobody disputes that the surrender value is ordinary income under I.R.C. §72(e).) The only dispute is how to treat the Surplus—the proceeds to the extent they exceed the cash surrender value.

In Favor of Capital Gain Treatment

Two arguments combine in favor of capital gain treatment. First, the federal cases that deal with the sale of a life policy, such as Gallun and Phillips, all predate the existence of the viatical settlement industry and therefore involved fact patterns in which the amount realized on the sale was in fact the cash surrender value. It does not follow, so the argument goes, that any excess over the cash surrender value should also be treated as ordinary income. This is buttressed by the second argument, i.e. that under I.R.C. §1211 a life insurance policy is a capital asset, and should therefore be taxed on a capital gain basis.

A statement of this argument appeared in a paper titled "The Tax Treatment of Life Insurance Settlements" that appeared in Tax News in 2000:

To deduce from the reasoning in Gallun and similar cases that gain on the sale of a policy is ordinary income in its entirety is not, we suggest, a necessary conclusion. It seems a given that the amount of the gain, up to the excess of the cash surrender policy over the policy`s tax basis, should be ordinary income since it represents deferred accumulated invested income. But the excess of the selling price of the policy over its cash surrender value represents something else.

The life insurance policy itself is a capital asset under section 1221, since everything is a capital asset under that section unless specifically listed as not being such. Such a life insurance policy is certainly not stock in trade, or property held for sale to customers, or anything else listed in section 1221. Since the policy is a capital asset, and since the "something else" represented by the excess of the selling price over the cash surrender value is an appreciation in value of that policy over and above the accumulated income, the proper tax treatment should be to accord it capital gain. We know of no cases holding to the contrary.

The §1221 branch of the argument is popular among life settlement providers, but it is not conclusive. Of course, every asset is a capital asset apart from those specifically excluded in §1221, but not every capital asset is taxed on a capital gain basis. Those old federal cases, Gallun» and Phillips, stand for the exact proposition that gain realized on the sale of a life policy—at least up to the cash surrender value—is treated as ordinary income. Thus, the §1221 argument comes down to the claim that because the Surplus is "something else" than "deferred accumulated investment income," it deserves different treatment.

Further support for the capital gains position comes from a footnote in the Phillips case:

[I]f a policy holder was afflicted with a disease which would result in his death in the near future, he could, if in need of cash, assign his policy for an amount in excess of that receivable under the policy and as to such excess, treat the same as capital gain.

Since the proceeds did not exceed the surrender value in Phillips, the statement in the fooootnote is hypothetical. Thus it might be risky to definatively rely on a footnote in a case from 1960 as conclusive of the issue.

Against Capital Gain Treatment

Though the federal cases did not involve proceeds greater than surrender value, there is no reason to think they are limited to their facts. Some courts have been aware of the capital gain issue. For example, the Seventh Circuit in Gallun says that:

Congress did not intend to permit, even through medium of a bona fide sale, the conversion of what is the equivalent of ordinary income into a capital gain . . . . [T]he increments realized upon the assignments were primarily attributable to accumulated interest, taxable to petitioners as ordinary income upon receipt under section 61(a)(4). We therefore hold that the entire gain realized on the assignments was ordinary income.

Certainly this is directed toward the taxpayer who sought to "convert" his surrender value into capital gain, but it does not foreclose the position that the Surplus should also be treated as ordinary income (nor does it foreclose the position that the Surplus should be treated as capital gain).

There is no way to definitively settle the issue by reference to the old cases or, as explained above, by reference to LTR 9443020. As the life settlement industry continues to grow, it is likely that the IRS will rule on the capital gain question. When it does so, it will decide in the absence of direct authority for either position.

Life Settlements and Section 1035 Exchanges

A §1035 exchange usually operates as a direct exchange of one policy for another between insurance companies (or by the same insurance company). No money passes through the policyholder`s hands. One may ask whether the same result holds if money does pass through the policyholder`s hands as would be the case with life settlement proceeds. What if an escrow agent is used?

The argument for allowing life settlements to be used in §1035 exchanges is simply that previous cases have allowed a policyholder to effect a §1035 exchange with funds that have passed through his or her hands. Proponents point to Greene v. Comm`r, 85 T.C. 1024 (1985). In Greene, a policyholder desired to make a §1035 exchange of an annuity for another annuity, but the insurance company refused to permit this. Instead, the company issued her a check which she immediately endorsed as payment for the new annuity.

The IRS argued that the transaction couldn`t be a §1035 exchange because the annuitant had no "binding obligation" to use the surrender proceeds to purchase the new annuity. The Tax Court, reasonably, found this argument somewhat beside the point. Here, the annuitant wanted to do a §1035 exchange but was prevented because the insurance company did not cooperate. She used the funds to buy the new annuity immediately. Intuitively, this looks like an exchange. To support intuition, the court referred to Rev. Rul. 73-124, 1973-1 CB 200. Here, a §403(b) annuitant surrendered his interest and immediately paid the proceeds into a new §403(b) annuity of the same employer (under a "binding agreement," which may explain the IRS`s argument in Greene): "In a single integrated transaction, the employee then surrendered his entire interest in the first contract to the insurer in exchange for a check which he immediately endorsed and paid over to the employer for use in providing benefits under the second contract." This would accord with the intuitive idea that the "total transaction" is a §1035 exchange "provided the proceeds received upon surrender are applied immediately to the purchase of a second annuity contract for the same employee."

But relying on Greene is risky. First, Greene is of limited use because it assumed that the transaction was a §1035 exchange. The Tax Court was concerned to reject the IRS`s "binding obligation" argument. But of course what is really at issue is whether a life settlement followed by a purchase of a new contract is a qualifying §1035 exchange in the first place. Even if an escrow agent held the settlement funds, could the IRS successfully argue that a life settlement followed by a new purchase is sufficiently different from a conventional 1035 exchange, and thus deny like kind exchange treatment? This remains to be seen.

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