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Unresolved Tax Issues in Viatical and Life Settlements

Bruce Evans, Tim Fontenot,
Barbara Scofield, Bill Shoemaker, and Robert Walsh

Viatical and life[1] settlements refer to the ownership transfer of a life insurance contract for valuable consideration. These settlements provide seller liquidity and investor return that has little correlation with other asset classes and investment markets. The pricing of life settlements, and thus the funding to individual policyholder sellers, are directly affected by the tax consequences of the proceeds subsequently paid to investors. This article explores the current tax environment for life settlements and explores possible tax contexts that would affect the sharing of the insurance proceeds among the insured seller, the investor, a life settlement company, and the various tax authorities. Alternative interpretations of the life settlement transaction are provided so policymakers can make informed choices with respect to tax, as well as social, policy involving the terminally-ill.

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The longstanding choices of the insured and their heirs, receiving the cash surrender value of a life insurance policy or waiting for the proceeds at death, are contrasted with life settlement options that offer returns to investors in the form of ordinary income, capital gains, or tax-free subrogation or assignment. Obviously, the option that provides the greatest current funding to the insured and the greatest return to the investor is the tax-free life settlement subrogation or assignment, which preserves the original tax-free character of life insurance transactions.

Overview

The first section of this article describes the life settlement market, its stakeholders, and individual investor perspectives. It then provides a general example of the life settlement contract and its functions. Next, the general tax treatment of life settlements for investors in these policies is investigated. Subsequently, the alternative tax treatment are considered. Finally, the comparative implications of the tax treatment are demonstrated.

The Life Settlement Market

The life settlement market began as the sale of life insurance policies by the terminally-ill to another party for less than the death benefit of the policy. The new policyholder is responsible for any premiums after the transfer and, upon death, receives the death benefit from the policy. Since transferees pay less than the face amount of the policy, they receive some return on this investment, depending on how much

longer the transferor lives after the transfer.

As these life settlements have grown over the past dozen years, the market has shifted from institutional investors to include individual investors as well. This form of secondary market for life insurance policies has risen from $13 billion in face amount of policies transferred in 1995 to $160 billion in 2004 (Simon and Schmitt 2006).

The current life settlement market is divided into the segment for the terminally-ill insured/ policyholder and the segment for any life insurance policy sale by someone else. While institutions can participate directly with an insured, individual investors typically use an intermediary to match potential sellers and potential investors. The Life Settlement Association (2007), a trade association for companies involved in viatical and life settlements, has members from 58 brokers who negotiate sales on behalf of sellers spread across 48 states plus the District of Columbia. On average there are 11 licensed brokers who are members of the Life Settlement Association in each state.

Life settlement companies provide the services that coordinate the sale and investment. The due diligence and the paperwork in the public offering of life settlements are substantial. The life settlement company verifies information about life expectancy of the insured and obtains authorization from beneficiaries. Several individual investors may participate in ownership of a single life insurance policy, and each individual investor may purchase an interest in several life insurance policies. The life settlement company manages the payment of subsequent premiums through an escrow account, tracks notification of deaths, and receives and distributes the life insurance proceeds. They have a dual marketing role in both establishing contacts with those interested in receiving accelerated death benefits and identifying appropriate investors. The closing costs, including the due diligence, prepayment of premiums for a projected period and commissions to brokers, usually amount to ten to fifteen percent of the investment/purchase price of the insurance policy. These closing costs are typically paid by the insured from his or her proceeds and do not affect the return to investors.[2]

All parties to the sale are considered to benefit.[3] The original policyholder is able to sell his policy for an amount substantially greater than the cash surrender value typically found in whole life policies, and the investor is able to achieve a corresponding return on this life settlement contract while avoiding most of the risks associated with the equity markets and far exceeding the current market rate of a low risk bond. The investor retains the uncertainties of when the policy will mature since it depends on when the insured dies, and the possible payment of additional premiums if the insured lives beyond the projected period. Within these investment parameters, the risks for the investor are generally diversified by the investor purchasing an ownership interest in several policies of various insured persons.

Prior to the emergence of the life settlement industry, taxation of life insurance proceeds was well defined. When an individual dies, Section 101 of the Internal Revenue Code classifies the life insurance proceeds as generally free of federal income taxation to the beneficiary.[4] Terminally-ill individuals frequently sold their policies in the 1980's and 1990's, precipitated principally by a rise in terminally-ill AIDS patients. Section 101(g)(1)(A) and 7702B of the Internal Revenue Code were added by the *Health Insurance Portability and Accountability Act of 1996* and clarified that proceeds from the sale of a life insurance policy to a life settlement company are a tax-free death benefit to the terminally-ill patient (Raby and Raby 2000). [5]

The taxation of the eventual proceeds of life policies to investors has not been directly addressed in the tax code. The current tax treatment is based upon precedent from court cases for ordinary income tax treatment of the life settlement proceeds to the investor. The following example assumes the tax-free treatment of proceeds to the insured seller and ordinary income tax treatment for the proceeds to the investor.

Basic Example of a Viatical/life Settlement Transaction

An elderly, terminally-ill life insurance policyholder seeks to sell her $1,000,000 face value death benefit policy as soon as possible for as much money as possible as outlined in Figure 1. She desires to obtain cash now while she is living rather than later for her estate or heirs upon her death, and she qualifies for tax-free treatment of her proceeds. The insured has paid total premiums of $175,000 over the life of the policy so far, and the cash surrender value is $200,000. The policyholder has a life expectancy of three years, but some potential for survival to five years. The investor conservatively bases his offer on the outside time of five years.

In this case, the investor offers $500,000 to the policyholder in order to become the new owner of the policy and name himself the new beneficiary. Closing costs of $75,000 cover the commission for the insurance broker, due diligence of the life settlement company, five years of future premiums, and overhead and profit of the life settlement company. Assuming the policy is paid upon death at the end of five years, the investment will provide $425,000 to the insured immediately as reflected in Panel A and yield 14.87 percent compounded annual return to the investor (for more information as to how this compounded annual return varies by survival period and tax treatment, see Figure 3, page 17, which reflects declining returns for longer survival periods).

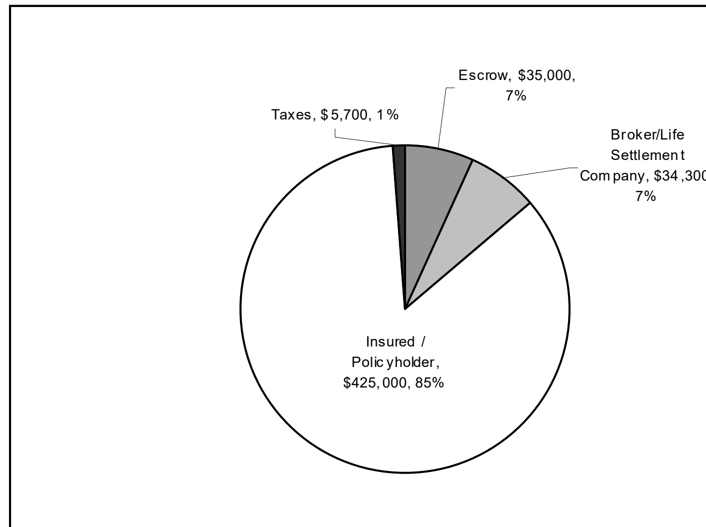
Panel B provides a comparison of the distribution of the proceeds of the life settlement when the insured/policyholder does not qualify as terminally-ill/chronically-ill and must pay taxes at receipt of the life settlement proceeds. Note that current tax policy offers a $42,000 benefit to the terminally- or chronically-ill insured seller over the average senior citizen insured seller.[6]

The alternatives reflected in Panels A and B provide current liquidity that is absent if the policy pays the estate, or heirs, at death. The alternatives are larger than the equally liquid cash surrender value shown in Panel C. Note that the taxes at the time of the life settlement transaction are solely those paid by the broker on his fee income and by the life settlement income on its earnings.

Figure 1
An Example of Distribution of Life Settlement Investment

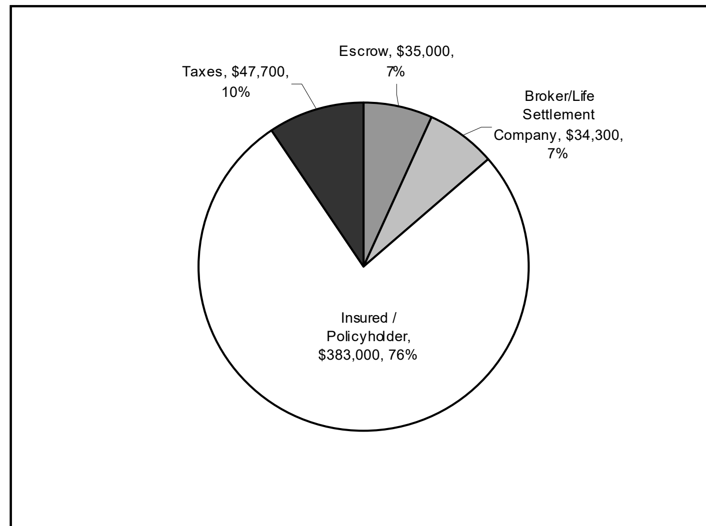
Assumptions:	
Face Amount of Policy	$1,000,000
Premiums Paid	$175,000
Cash Surrender Value	$200,000
"Maximum" Life Expectancy	5 years
Price Paid in Life Settlement	$500,000
Closing Costs	$75,000
Annual Premium on Life Insurance	$7,000
Broker Commission as % of non-premium closing costs	50%
Life Settlement Company Return on Closing Costs	10%
Ordinary Income Tax Rate to Life Settlement Company	35%
Ordinary Income Tax Rate to Broker	25%
Ordinary Income Tax Rate to Insured/Policyholder	33%
Capital Gains Tax Rate to Insured/Policyholder	15%

Panel A
Terminally- or Chronically-Ill Insured Policy Seller Distribution of Investor's $500,000 Payoff



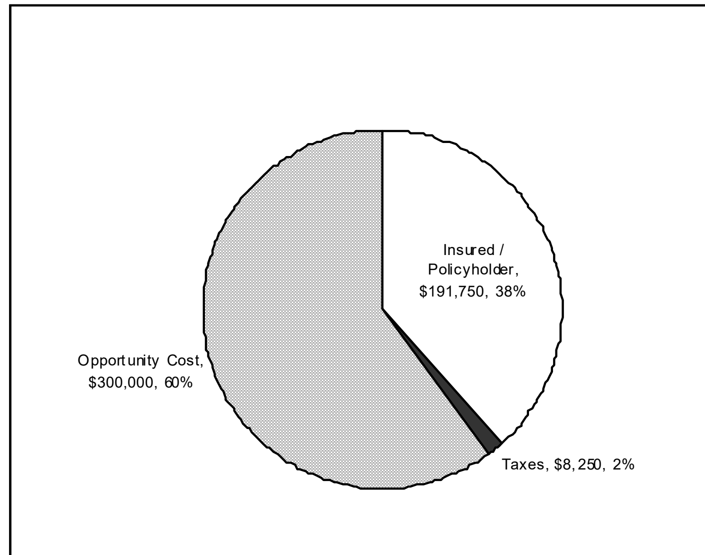
Note: Tax is the sum of (a) tax paid by the broker on fee income [($75,000-$35,000)*.50*.25] and (b) tax paid by the life settlement company on its profits [($75,000-$35,000)*.50*.10*.35]. The assumed tax rate is the maximum marginal tax rate by tax entity, consistent with other studies and shown to be reasonable by Jensen, Kaplan and Stiglin, 1989.

Panel B
Senior Citizen Insured Policy Seller Distribution of Investor's $500,000 Payoff



Note: Tax is the sum of (a) tax paid by the broker on fee income [($75,000-$35,000)*.50*.25], (b) tax paid by the life settlement company on its profits [($75,000-$35,000)*.50*.10*.35], (c) tax paid by the insured on the proceeds over the cash surrender value at the capital gains rate [$425,000-$200,000)*.15] and (d) tax paid by the insured on the difference between the premiums paid and the cash surrender value at the ordinary income rate [($200,000-$175,000)*.33].

Panel C
Cash Surrender Value Only Distribution Based upon Investor's $500,000 Payoff Equivalent



Note: Tax is ordinary income tax on the difference between the premiums paid and the cash surrender value [($200,000-$175,000)*.33]

The taxability of the $500,000 gain realized by the investor when he collects the $1,000,000 face value upon the death of the insured is the subject of the subsequent analyses. To focus on the primary issue of this article, the alternatives all assume that the transaction would be tax-free to the insured if she participates in a life settlement and to the heirs if they receive the face value at the insured's death.

Federal Tax Ramifications of a Viatical/life Settlement Payment

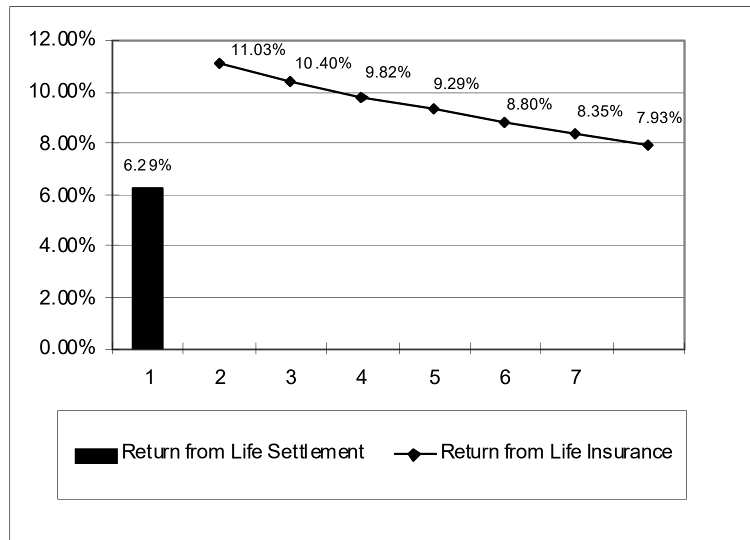
The tax ramifications of the sale of a life insurance policy to a life settlement company and subsequent sale by the company to an investor, in most cases, are more clearly defined, specifically the tax treatment for the terminally-ill seller. However, current ordinary income tax treatment for the investor is predicated upon legal precedent in which a capital gain argument has substantial support.

Continuing the previous example, the return to the insured seller and her heirs from the life settlement represents an immediate tax-free 6.29 percent compounded annual return on premiums paid reflected in Figure 2. Should the insured continue the policy until her death, the return to her estate, or heirs, is a function of her survival and declines from 11.03 percent with a single year of survival to 7.93 percent with seven years of survival. Thus, the insured has the classic investment decision of immediate certain proceeds versus a variable future return. In the absence of life settlements, the only alternative that also provides immediate liquidity is ending the policy and receiving the cash surrender value, as reflected in Panel C. In this example, life settlements provide 128 percent more cash ($425,000 versus $191,750) than the cash surrender value alternative.

On the other hand, suppose the woman sells the $1,000,000 policy to a life settlement company for $425,000 net cash, which is tax-free to her. The life settlement company then sells it to an investor(s) for $500,000, and the investor can expect to receive proceeds of $1,000,000 at the policyholder's death. The difference between the investor's payment and the

Figure 2
Comparison of Return to Insured/Heirs from Life Insurance vs. Life Settlement for Survival Periods of One to Seven Years

Assumptions:	
Face Amount of Policy	$1,000,000
Price Paid in Life Settlement	$500,000
Closing Costs	$75,000
Annual Premium on Life Insurance	$7,000
Total Premiums Previously Paid at Time 0	$175,000
Years of Premiums Previously Paid at Time 0	25 years



insured's receipts include escrow for future premiums, compensation to the broker, and payment for closing costs and profit of the life settlement company. When the elderly woman then dies, the investor receives $1,000,000 in cash. The difference between the investor's proceeds of $1,000,000 and his basis or cost in the asset of $500,000 is realized gain of $500,000.[7]

How Should this Realized Gain Be Taxed?

The Research Institute of America's *Federal Tax Coordinator* states, "Any taxable gain on the sale or surrender of a life insurance contract is treated as ordinary income…" (Research Institute of America 2006 Para J-5307). The basis of this statement is the interpretation of a number of cases, including *Estate of Rath v. U.S.* (1979) and *Gallun v. Commissioner* (1964). In *Estate of Rath v. U.S.* (1979), Rath's wife purchased for around $11,000 the life insurance policy from her husband's corporation on her husband's life. A few years later, her husband died. The IRS assessed a tax on the difference between the life insurance proceeds of about $100,000 and the basis of $11,000 that Mrs. Rath had paid for the policy. The Sixth Circuit Court upheld the treatment of ordinary income to Mrs. Rath of about $89,000, saying such treatment was consistent with Section 101 (a) (2) of the Internal Revenue Code, which covers transfer for valuable consideration. One issue is not that the Sixth Circuit found the amount of $89,000 to be taxable, but that it was labeled as ordinary income and not capital gain.

In *Gallun v. Commissioner* (1964), the taxpayer

transferred several policies worth a total of $250,000 in face amount with an accumulated premium cost of around $121,000 and a cash surrender value of $159,000 to the corporation in which he was CEO. He claimed a capital gain of $38,000. Both the Tax Court and the Appeals Court ruled this $38,000 was ordinary income, since it represented the accumulated of deferred interest income, the excess of cash surrender value over premium cost. To allow capital gains treatment would have been effectively allowing conversion of ordinary income into capital gains.

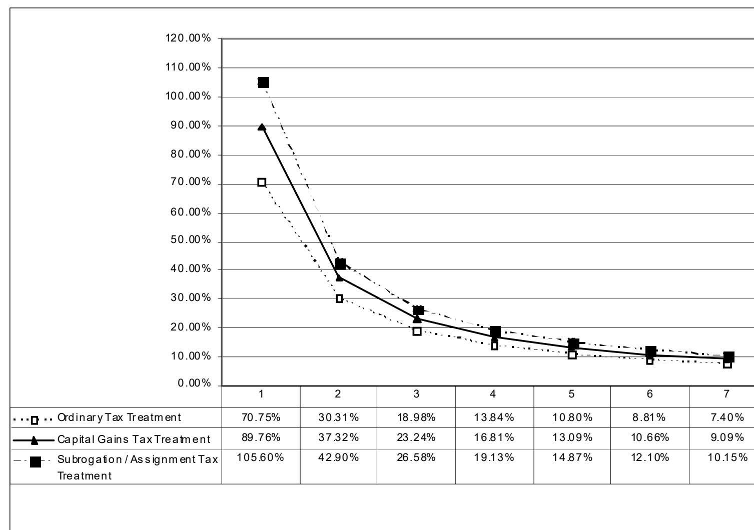
On the basis of these two legal cases, typical life settlements, such as the example, would have the following tax result. The $1,000,000 proceeds less the basis, or cost, of the policy of $500,000 is ordinary income of $500,000 to the investor (see Figure 3). The $500,000 could represent *interest* from the investment in the policy; hence, there would be ordinary income tax treatment.

Or Is It?

First, Section 101(a) (2) defines the "transfer for valuable consideration" as merely giving rise to income, not whether it is ordinary income, capital gain, or non-taxable income. In an article by Magner and Leimberg (2006), some life settlement companies specifically market their products with the statement "…amounts received in excess of cash surrender value are generally taxable as *capital gain*…" along with the words following that

Figure 3
Comparison of After-tax Returns to Life Settlement Investor
For Survival Periods from One to Seven Years

Face Amount of Policy	$1,000,000
Closing Costs	$75,000
Price Paid in Life Settlement	$500,000
Annual Premium	$7,000
Life Expectancy ("Max")	5 years
Ordinary Tax Rate to Investor	33%
Capital Gains Tax Rate to Investor	15%



	1	2	3	4	5	6	7
Ordinary Tax Treatment	70.75%	30.31%	18.98%	13.84%	10.80%	8.81%	7.40%
Capital Gains Tax Treatment	89.76%	37.32%	23.24%	16.81%	13.09%	10.66%	9.09%
Subrogation / Assignment Tax Treatment	105.60%	42.90%	26.58%	19.13%	14.87%	12.10%	10.15%

statement of "please consult your own tax and financial advisors …."

It is well established that the gain on the surrender of a life insurance policy is ordinary income to the insured (Section 72(e)) unless specifically to a life settlement company or other purchaser from a terminally-ill person. This tax treatment is consistent with the position that the ordinary income is created from the excess of the cash surrender value over premiums paid. Yet, life settlement companies have argued that a life insurance policy is a capital asset in the hands of one of its investors; therefore, any proceeds over the basis or cost of the policy should be capital gains.

The capital asset argument has merit on two counts. First, the life insurance policy itself is a capital asset under Section 1221 of the Internal Revenue Code. That section defines everything which is not a capital asset (stock in trade, property held for sale to customers, etc.). Since life insurance policies are not listed, they can be considered capital assets. Sales of capital assets generate capital gains, either short-term or long-term, but capital gains nonetheless.

The second case for labeling the proceeds less basis as a capital gain is more complex but also worth consideration. Suppose in the above example, before the elder dies, the investor, who has a basis already in the policy of $500,000, finds someone else who is willing to pay $800,000 for the policy. The sale is consummated, and the original investor now has taxable income of $300,000 ($800,000 of proceeds less $500,000 of basis). This would appear to be a capital gain, being a return from the sale of an investment. By parallel, the same argument is made that, upon death, the policy ends with a "sale" of the policy to the original insurance company for $1,000,000, hence a capital gain of $500,000.

The capital gains treatment of the insurance proceeds that are more than the investor's basis increases the return of the investor, if this case is treated statically. However, changing the after tax return to the investor would allow other investors to compete for the policy at a lower cost. Thus if the investor were originally seeking an after tax 10.80 percent return, as in this example, then the change in tax treatment would enable the investor to earn this return with an increased offer to the insured/ policyholder. Solving for the investment that would result in an after-tax rate of return of 10.80 percent given capital gains treatment, the investor will make an offer price of $554,000, a 10.8 percent increase, freeing funding that previously paid for taxes into direct funding to the insured, who receives it on a tax-free basis.[8]

Alternatively, capital gains treatment may still be available to some investors in some circumstances even if ordinary tax treatment holds. An actual resale of a life settlement by one investor to another in a tertiary market for already vetted and packaged life settlements would generate capital gains to the original investor.[9]

The Case for Alternative Tax Approaches

Challenges are present in the legal interpretation concerning applicable taxation of life settlement investment gains. Taxing the investor's gain as ordinary income or capital gains, as previously described, changes the tax character of the original life insurance transaction. The twin challenges offered advance alternative positions that such gains are not to be taxed at all, being instead either a) subrogation recoveries or b) assignment proceeds.

Subrogation is defined as follows:

> The substitution of one person in place of another with reference to a lawful claim… so that he who is substituted succeeds to the rights of the other (*Black's Law Dictionary*, 4th edition, 1995).

> The substitution of one for another as a creditor so that the new creditor succeeds to the former's rights (*Webster's*, 1967: 876).

Subrogation arises when one individual

> satisfies the debt of another as a result of a contractual agreement {whereby} claims are kept alive for the benefit of the party which pays the debt. Subrogation is a highly favored remedy that the courts are inclined to extend and apply liberally. … Subrogation most commonly arises in relation to policies of insurance; the legal technique is of more general application (Subrogation, 1998).

The right of subrogation may be assigned, granting the right to file a claim or instigate a lawsuit if the primary party does not do so. Legally, subrogation places another in the place of the original party with all the legal rights afforded thereunder.

Also note that this substitution does not imply gain or loss in the above definitions. Subrogation, as routinely applied in the property and casualty insurance industry, means the substitution of the insurer in place of the insured for the purpose of claiming indemnification (recovery) from a negligent third person for a loss covered by insurance (Rejda, 2004). Subrogation is often referred to as the insurer "stepping into the shoes" of the insured (Tramountanas, 2002). Property and liability insurers have engaged the principle of indemnity to recover from negligent parties amounts paid to their insureds under their insurance policies, using that industry's standard that indemnity is a legal exemption from liability for damages. The general rule in the property and liability industry is that the insurer is entitled only to the amount it has paid under the policy, although the insurer's recovery less expenses incurred during the pursuit of wrongdoers escapes taxation. This insurance-generated subrogation basis is linked and becomes relevant only for contracts of indemnity, leaving its applicability to life settlements untested. To anticipate a challenge arising out of the requirement that a life insurance contract requires the insured's insurable interest for property and liability insurance, such a requirement exists only at the time the policy is purchased (Harrington and Niehaus 2004). Thus subsequent investors holding the original insured's rights would not be required to have an applicable insurable interest.

Conventional subrogation originates from a contract; so does life settlement. Subrogation, applied to life settlement insurance contracts, nullifies tax application. Thus, the scope of subrogation, extended beyond property and liability insurance contracts and into life settlement insurance contracts, is a clear and consistent application.

A second atypical route to alternative tax treatment concerns assignment, defined as transfer of rights or property (*Black's Law Dictionary*, 1999). Within this proposition, a life settlement has contractual rights that are considered to be property and as such can be transferred to others. In an assignment, those rights inure to the investor's benefit. "Most contracts permit an assignment as long as the other party to the contract approves the assignment" (Bennett 2007). Thus, life settlement contracts seems to fit with the interpretation of assignment that is used in certain contractual situations. Some features of the life settlement market are set up to insure that the transfer of rights is unconditional, subject to payment of future premiums. A conditional transfer of rights would arise in a contractual exchange, requiring consideration that is vulnerable in case the assignee breaches the contract. It would be a conditional contract since the original insured remained responsible for the performance of the contract (e.g., payment of continuing premiums) if future requirements are involved. However, a part of life settlement contracts is the placement in an escrow account of the likely future premiums and the designation of the investor as the payee for any additional premiums. As with subrogation, there appears to be no taxable gain in such a transaction.

Subrogation or assignment interpretations of life settlements are

apparently untested applications. Their direct consequence would be tax-free treatment of the proceeds of life insurance from the insured seller to life settlement investors Referring to Figure 3, the change in tax treatment would enable the investor to earn his required after-tax return with an increased offer to the insured policy seller. Solving for the investment that would result in a rate of return of 10.80 percent given tax-free treatment, the investor would make an offer of $598,750, a 19.75 percent increase over ordinary income treatment, and an 8.08 percent increase over capital gains treatment, freeing additional funding that previously paid taxes into direct funding to the insured, who receives it on a tax-free basis.[10]

Conclusion

This article presents alternative tax treatments for life settlement transactions. All tax treatments presented have some support in tax accounting and economic literature. The current Internal Revenue Code embraces a tax treatment limiting funds to the insured seller and investors. This article presents arguments that such treatment of proceeds from life settlement policies to investors should be taxed as a capital gain in excess of basis. Further arguments are made, consistent with application of subrogation and assignment from the property and liability industry, that none of the proceeds are taxable.

Endnotes

1. The term “viatical settlement” is used exclusively for life insurance sales by the terminally ill or chronically ill policyholder. “Life settlement” is used for both life insurance sales by any senior citizen and for all life insurance sales. “Life settlement” is used in this article even though it focuses on settlements for the terminally- or chronically-ill, as it is the more common term used in practice.

2. While this article describes the actual practice of life settlement companies with respect to closing costs, who pays the closing costs is a matter of convenience in the transaction rather than a factor that actually affects the funding to the insured. If the closing costs were paid by the investor, then the investor would be willing to pay less for the investment, mitigating any additional proceeds to the insured from this arrangement.

3. The heirs have been characterized as “losers” in life settlement transactions. However, since they, presumably, did not originally pay the premiums and could alternately fund the insured/policyholder to preserve their right to the death benefit, a life settlement transaction becomes an alternative when the liquidity benefits predominate.

4. There are also estate tax consequences to life insurance, but these depend on many factors and are outside of the scope of this article.

5. The IRS in IRC section 101 (g) defines "terminally ill" as one who is medically certified to have an expected life of twenty-four months or less. However, the tax benefit is also extended to the "chronically ill" if there is an annual certification that the person is unable to perform two activities of daily living or requires supervision due to cognitive impairment and the proceeds are used to pay for qualified long-term care. Partial exclusion is available when proceeds are received periodically.

6. The tax treatment for senior citizens who do not qualify as terminally ill or chronically ill is described in Goldstein, Harter, and Holaday (2006) and Magner and Leimberg (2007).

7. While the theoretical discussion assumes the survival matches the maximum life expectancy of five years, other survival terms affect the basis of the life settlement investment due to the impact of premiums. If the survival is less than five years, then unused premiums are paid to the investor and the basis is decreased. If the survival is more than

five years, then premiums are paid as due by the investor and the basis is increased. Calculations in Figure 3 include premium effects.

8. This example assumes there would be no material changes in closing costs to the broker/life settlement company.

9. A tertiary market is not well-established at this time. Life settlement investors are advised that life settlements are illiquid investments to be held until their maturity at the death of the insured. However, transactions between institutional investors and life settlement companies have included securitized portfolios of life settlements which facilitate a tertiary market (Legacy Benefits 2007).

10. This example assumes there would be no material changes in closing costs to the broker/life settlement company.

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