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SETTLING END-OF-LIFE NEEDS

Appreciating Life Insurance for Gift-Tax Purposes

by Larry Simon

With the tax season nearly behind us, what rings especially clear is the ever-looming question of what to do if a client transfers an insurance policy as a gift. Dept. of Treasury regulations provide guidelines to approximate a policy value for gift-tax purposes. The regulations apply to a gift that involves transferring all ownership rights in a life insurance policy. It is generally considered a taxable gift, which is measured by the policy replacement value.

Enter life settlements. When these tax regulations went into effect, life settlements were not yet an option. Often, the only way in which the regulations provide guidance is through inference.

When the insured is a senior citizen, the policy's replacement value may be greater or less than the value that would be placed on the policy in a life settlement. If so, it is arguable that the value determined by reference to a life settlement should control it.

Whenever a policy is transferred for estate or financial planning purposes, there must be a determination of whether there is an after-market for the policy. For example, if the policy is transferred by gift, an after-market is likely to increase the amount of the taxable gift substantially. A sale for less than the after-market value will have a gift component, which will make the three-year rule applicable to the transfer.

Either way, if there is an after-market for the policy, the value would one-up the traditional replacement insurance value rules and make the willing buyer/seller rule applicable for determining value.

Furthermore, a life settlement can be a means of doing the following:
-Avoiding the IRS three-year look-back rule relating to the transfer of life insurance policies.
-Maximizing the proceeds to be transferred to the insured's family or other beneficiaries.
-Reducing estate taxes by removing the death benefit from the estate.

The tax consequences from a life settlement transaction vary. In general, all life settlement funds are received tax-free up to the "basis," which is the amount of investment a taxpayer has in the asset. Unless the policyholder is terminally ill, funds received in excess of basis are treated as ordinary income or capital gain. The proceeds may be tax-free.

Many find it beneficial to donate highly appreciated assets to charity to get a current income-tax deduction that is equal to the asset's fair market value, rather than their basis in the asset. However, the donor may not be willing or able to give up the income since such appreciated assets are often income producing, such as stocks and real estate. As an alternative, life settlement proceeds can make up some of the lost income of the highly appreciated, income producing assets.

In summary, life settlements usually involve three layers of taxation to individual policy sellers:
1. Zero tax -- up to the owner's basis, since it is a return of capital.

2. Ordinary income -- from the basis to the policy's cash surrender value.

3. Long-term capital gains -- from the higher of the cash-surrender value or the Federal income tax basis to the net settlement proceeds, since this is a capital asset.

Larry Simon is director, CEO, and president of Life Settlement Solutions Inc., a life settlement provider based in San Diego, Calif. LSS and its management have purchased life insurance policies with nearly $1 billion aggregate face value to date. To reach the company, call (858) 576-8067. For more information about tax implications as they relate to life settlements, policy owners should consult with their independent tax
advisors.