Tax Implications for Life Insurance Investors

In addition to providing guidance for owners of life insurance policies who sell or surrender their policy (which was discussed in a recent article), the Internal Revenue Service ("IRS") provided guidance for investors in life insurance policies. The Revenue Ruling provided a number of factual scenarios concerning the tax implications to an investor who purchases a life insurance policy and: (a) the insured subsequently dies prior to any other policy transfers (death benefits payable to the investor); and (b) sells the policy to an unrelated third-party prior to the insured's death. Each scenario involved a 15-year term life insurance contract with no cash surrender value.

A. Death Benefits Paid to the Investor

Upon the subsequent death of an insured, the payment of death benefits to an investor who purchases a life insurance policy from an unrelated third-party is subject to taxation at ordinary income rates. Under the transfer for value rule, if a life insurance contract is transferred for valuable consideration, the death benefit exclusion is limited to the amount of consideration paid for the contract, plus any premiums later paid by the investor. The investor will recognize ordinary income in an amount equal to the difference between: (a) the amount of death benefits paid to the investor; and (b) his adjusted basis, which is the amount paid for the policy plus any additional premiums paid to keep the policy in force.

Unlike a policy owner who must reduce his adjusted basis in the insurance policy by the amount of the cost of insurance charges, an investor does not have to reduce his adjusted basis by the cost of insurance. The cost of insurance protection was enjoyed by the policy owner as the beneficiary of the policy, the investor did not purchase the life insurance contract for protection against any economic loss upon the insured's death, but solely as an investment. The investor acquired and held the contract solely with a view to profit, and paid additional premiums to prevent the lapse of the investor's purely financial investment, the contract.

B. Investor Sells the Policy to an Unrelated Third-Party

The IRS considers a life insurance policy a capital asset in the hands of the investor. It follows that the sale of the contract by the investor to an unrelated third party triggers capital gains tax. The investor will be subject to short term capital gain if the policy is held for less than one year and long term capital gain for a policy held one year or more. The analysis set forth above is also used to determine the amount of capital gain, i.e. the sale price less the adjusted basis in the hands of the investor equals the amount of capital gain. The adjusted basis is equal to the price paid for the policy, plus any additional premiums paid to keep the policy in force.

The published guidance provides investors in life insurance contracts important guidance, but the Revenue Ruling does not address tax implication to an investor who purchases a life insurance contract with cash value component.

If you are considering investing in surrendered insurance policies, please contact me to discuss the tax consequences of such a transaction at (508) 459-8007 or cbilodeau@fletchertilton.com.

RESPONSIVE SOLUTIONS

Two simple words that explain our commitment to you. Being responsive is a critical element in building a strong attorney-client relationship. Whether you are a new or existing client, we'll be quick to respond to your needs with the knowledge necessary to find solutions to your legal concerns.

www.fletchertilton.com

THE GUARANTY BUILDING
370 Main Street, 12th Floor
Worcester, MA 01608
TEL 508.459.8000 FAX 508.459.8300

THE MEADOWS
161 Worcester Road, Suite 501
Framingham, MA 01701
TEL 508.532.3500 FAX 508.532.3100

CAPE COD
1579 Falmouth Road, Suite 3
Centerville, MA 02632
TEL 508.815.2500 FAX 508.459.8300