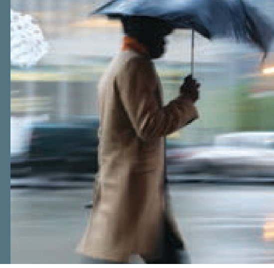


COMMITTEE REPORT:
INSURANCE

By **Jon B. Mendelsohn**

Tax Reform Drives New Discussions About Life Settlements

Implications for estate-planning professionals

Within hours of the passage of the 2017 Tax Cuts and Jobs Act (the Act), the blogosphere lit up with articles about how provisions in the Act would suddenly induce more life insurance policy owners (POs) to do a life settlement—a transaction in which the PO sells his existing policy to an unrelated third party for a cash amount greater than the surrender value and less than the death benefit. POs have a legal right to sell their existing life insurance in the regulated and institutional secondary market; however, for many, it's an unknown option. For almost a decade, the life settlement industry has worked with regulators, lobbyists and consumer advocates to educate the public about life settlements as a way to turn an unrealized asset into a means to pay for an individual's retirement or caregiving needs.

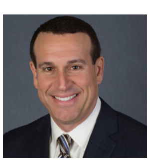
Two provisions in the Act, the doubling of the estate tax exemption and more favorable tax treatment for the PO selling his policy, are the reasons the life settlement community is excited about the Act. What are the implications for estate-planning professionals advising senior clients?

Estate Tax Exemption

The Act increased the estate tax exemption to $11.18 million per individual and $22.36 million for married couples and is expected to increase life settlement activity. Because life insurance has long been the cornerstone of estate and tax planning for high-net-worth (HNW) individuals, insurance and estate-planning professionals may have clients who decide they no longer need the insurance coverage for its original purpose, which was to protect their estates. Clients thus will benefit from knowing how much their policy is worth if they sold the policy as a life settlement for fair market value (FMV). The life settlement market provides, on average, eight times more than the surrender value to POs. Prior to a PO deciding to surrender or lapse a policy, documenting a file on the secondary market value of the policy will provide clarity of the viability of a life settlement as a potential exit strategy. As advisors discuss new planning applications for the insurance coverage post-Act, they may need to get answers to several questions if planning leads to the exploration of all available non-forfeiture options:

- What are the tax ramifications to the PO under the Act when the policy is sold?
- What's the likelihood of the insured(s) outliving the 2026 sunset period?
- What if the insured lives 20 percent to 30 percent longer than expected? How much more premium would need to be set aside or in reserves? Are those dollars being taken away from other planning areas?
- Does the policy provide an important benefit to the the PO and/or beneficiaries above and beyond offering estate protection that may no longer be needed?
- Can the benefit previously needed for estate protection now be donated to charity? Will it be a potential burden, or can it provide an immediate cash benefit to the charity? How do you determine present value?
- How does the life settlement value compare to the policy surrender value? If it's greater, does that open up new planning scenarios?
- Is maintaining premium payments in the best interest of the PO compared to other options? Could the proceeds of a settlement and reallocation of the premium payments provide more value to the plan?
- Does my client's convertible term insurance policy have value on the balance sheet for an amount greater than $0? Would an unexpected influx of cash have a benefit?
- Would my client benefit from selling part of the policy while retaining a portion of the benefit?

While the increased estate tax exemption in the Act impacts only a segment of HNW clients, it follows on the heels of the 2012 American Taxpayer Relief Act (ATRA), which increased the estate tax exemption from the previous level. We saw an uptick in POs wanting to sell all or part of their permanent or term life insurance when ATRA was enacted in 2012, and we're seeing the same in-



Jon B. Mendelsohn is CEO of Ashar Group in Orlando, Fla.

crease in life settlement activity as a result of the Act. The life settlement market benefits seniors more than any other age group, which is why there's seemingly an increase in activity after favorable estate tax laws are passed.

Tax Treatment for Life Settlements

In 2009, a much-anticipated revenue ruling was released regarding the tax consequences of a life settlement (Rev. Rul. 2009-13). Many advisors felt that the revenue ruling would create awareness of this option for POs, as well as result in dignifying its place in the planning community. Instead of bringing clarity to financial professionals, advisors and their clients on the tax treatment of the sale of the policy, more questions than answers were uncovered in this emerging market.

The problem created by the revenue ruling was that tax treatment for policy sale was treated differently from the tax treatment for a policy surrender, which hampered policy sales, negatively impacted consumer confidence and made it more difficult for advisors to calculate taxes for life settlements. The ruling imposed a formula on life settlements for calculating basis that required deducting the cost of insurance (COI) from the policy's tax basis. COI is a calculation that one would think is provided by the insurance carrier; however, it became abundantly clear that wasn't a common practice. Advisors hit road blocks in their planning and often had to gather dozens of policy statements from past years to piece together their analysis. Many felt it was extremely difficult, if not impossible, to obtain. On the other hand, when a PO surrendered a life insurance contract, there were no such penalties or convoluted formulas imposed on the client.

The Act eliminates the requirement to remove COI from the cost basis of a policy sale, thereby putting life settlements on a level playing field with other non-forfeiture options, such as a policy surrender:

> Under the new law, effectively only the Section 72(e)(6) calculation will be used to determine cost basis or investment in the contracts. The retroactive effective date of the cost basis change may provide refund or recalculation opportunities for holders of contracts that were subject to a cost basis adjustment. Clearly, such opportunities will depend on the facts and circumstances of the transaction and consideration must be given to whether the applicable tax years are already closed.[1]

What does this really mean for clients who sell their life insurance policy on the secondary market? One benefit is a significant tax savings for the PO/seller. For universal life and term insurance policies, COI represents most, if not all, of the premiums paid. Now the premiums paid—which include COI—equals cost basis, thereby lowering the total tax obligation resulting from a life settlement. Another benefit is a more simplified tax calculation for tax professionals without the unnecessary obstacle of trying to determine the COI. (See "Prior vs. Current Methodology," this page.)

Ultimately, the revision to Rev. Rul. 2009-13 will bring more clarity to planning professionals and the clients they serve. With an aging population that's faced with the realities of outliving their savings and searching for ways to fund their independence and long-term care needs, life settlements might be the option that helps find the liquidity needed to solve today's issues. An ancillary benefit will also be freeing up the mental and financial bandwidth of their adult children who won't have to real-locate their planning dollars to fund their parent's needs. Instead, these 40 to 60 year olds will be able to focus on their own planning needs so they can avoid the compli-cated consequences of outliving their own financial plans.

Practice tip: When discussing life insurance scenar-ios and exit strategies as a result of the Act, be sure to secure an appraisal of FMV to make sure you consider all options.

Prior vs. Current Methodology

Interpretation of Revenue Ruling 2009-13 has changed

Prior Revenue Ruling 2009-13

Universal Life Policy — Example: Determination of Adjusted Basis and Tax Liability

Universal life policy, death benefit: $1 million; individual sells policy for $90,000. Premiums paid into policy: $64,000

Cost of insurance: $20,000. Cash surrender value: $30,000

Step 1: Computation of basis:

$64,000 premiums paid - $20,000 cost of insurance = $44,000 adjusted basis

Step 2: Computation of overall tax liability:

$90,000 sale amount - $44,000 basis = $46,000 taxable gain

2017 Tax Reform — Current Revision of Revenue Ruling 2009-13

Universal Life Policy — Example: Determination of Tax Liability

Universal life policy, death benefit: $1 million; individual sells policy for $90,000. Premiums paid into policy: $64,000

Cash surrender value: $30,000

Step 1: Computation of basis:

$64,000 premiums paid = $0 taxation for up to $64,000 of sale price

Step 2: Computation of overall tax liability:

$90,000 sale amount - $64,000 basis = $26,000 taxable gain as a longterm capital gain

— Jon B. Mendelsohn

Endnote

1. *https://taxnews.ey.com/news/2018-0027-president-signs-tax-reform-bill-with-numerous-changes-affecting-the-insurance-industry.*