

Are You Planning to Sell or Surrender Your Life Insurance Policy? Tax Treatment for the Policy Owner

The life insurance secondary market has grown tremendously in recent years providing policy owners, who may no longer need the coverage, with an additional income source. Yet the income tax consequences have remained unclear, and in certain cases still do remain unclear. The Internal Revenue Service (“IRS”) recently published guidance concerning the income tax consequences of: (a) the surrender of a life insurance policy to the issuing insurance company; and (b) the sale of a life insurance policy to a third-party. The two (2) Revenue Rulings provide guidance with respect to the income tax consequences to the policy owner and the investor who purchases the insurance policy in the secondary market. This article addresses only the income tax consequences to the policy owner who surrenders/sells the insurance policy.

TAX CONSEQUENCES TO THE POLICY OWNER

A. Surrender of Policy to the Insurance Company

The IRS determined that an insured who surrenders an insurance policy to the insurance company will recognize gain to the extent the amount received (the surrender value) exceeds the “investment in the contract” (the “inside build-up”). The “investment in the contract” will generally be the amount of premiums paid by a policy owner who has not received distributions or borrowed against the policy. Although different opinions exist among practitioners about the tax character of the gain on the surrender of an insurance policy, it is the IRS’s position that any gain is treated as ordinary income not capital gain.

B. Sale of Insurance Policy to a Third-Party

One would think that the sale of a cash value insurance policy to a third-party would result in similar tax consequences to the policy owner as surrendering the same policy. In fact the tax consequences are quite different. If the insured sells the policy to an unrelated third-party, it is the IRS’s position that the gain is bifurcated between ordinary income and capital gain. The IRS believes that the policy owner’s basis in the policy does not include the amount paid for insurance protection. It is likely

that the policy owner will recognize greater gain because the insurance protection portion of the premiums are excluded from basis. As mentioned above the “inside build-up” is treated as ordinary income. Any gain in excess of the “inside build-up” may qualify as gain from the sale or exchange of a capital asset and therefore capital gain.

A term insurance policy owner is likely to have little or no basis in the policy because the entire premium is used to provide insurance coverage. Arguably the only basis will be for premiums paid, for coverage not yet provided. There will be no ordinary income on the sale of a term policy because there is no cash surrender value and no “inside build-up”.

It is important to note that the IRS Revenue Ruling concerning sales of insurance policies to a third-party is applicable only to sales occurring after August 26, 2009.

CONCLUSION

The Revenue Ruling provides important guidance for policy owners interested in surrendering or selling their policy. However, a number of unanswered questions remain including whether cost of insurance protection from basis may be challenged or distinguished on the facts. If you are considering surrendering or selling your insurance policy 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