CHAPTER 61

Avoiding Tax on Life Insurance Distributions Before Death – Life Settlements and Viatication

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GETTING CASH OUT OF YOUR LIFE INSURANCE POLICY

You may find yourself needing cash from your life insurance policy. This might occur if you need money for living expenses, educational expenses for children or grandchildren, or for general investment purposes. If you have a life insurance policy with cash value inside of the policy, you may be able to access that cash.

There are generally two methods of accessing cash from your life insurance policy. First, you could keep your existing policy and borrow or withdraw the cash from the policy. Second you could either surrender or sell your policy in exchange for cash. Each method of accessing this cash may result in what is known as a taxable transaction, meaning you may have to pay either income tax or capital gains tax.

WITHDRAW OR BORROW

If you have a cash value type policy, such as a whole life, universal life, or variable life policy, you may be able to withdraw or borrow cash from your policy. The amount of premiums you have paid into your policy generally represent what is called your basis in your policy. If you wish to take this money out, you can withdraw it tax free, meaning you pay no income or capital gains taxes. However, any amounts withdrawn in excess of your basis are taxable to you as ordinary income.

You can also borrow money from your cash value life insurance policy. You will be required to pay back this loan to the insurance company, and you will usually not be required to pay any income taxes on this loan. One exception to this rule is if your policy is classified as a modified endowment contract, or a MEC. But if you have been paying premiums into your policy over time, your policy is probably not a MEC.

SELL OR SETTLE YOUR POLICY

The other method of obtaining cash from your life policy is to sell or settle the policy. If you find yourself wanting to terminate your permanent life insurance policy (or a term insurance policy that permits you to convert to permanent insurance), then there are essentially two markets to turn to: the life insurance company that issued the policy to you; or the secondary market.

If you contact your life insurance company to see what your policy is worth, it will have a price at which it will permit you to surrender the policy. This is generally referred to as the cash surrender value. This cash surrender value of the policy is determined by your insurance company and is usually based upon how much excess cash has accumulated or has been invested by the insurance company inside of your policy.

A cash surrender value is thought to be significantly less than a true market value of the same policy. This is because death is certain; and if death is certain, and if a policy will pay a contractual amount at a time in the future, the certainty of this event has value. The value is determined by the amount of the death benefit and the likelihood of the death. Therefore, for example, if your health has declined since the issuance of the policy, you may not likely live to your actuarial life expectancy. This means the policy will pay off sooner and the policy will therefore have greater value.

The cash surrender value of your policy in the eyes of your life insurance company is far different than the market value for your policy. The true market value of your policy may be three to six times the cash surrender value your life insurance company may be willing to pay. This difference, in recent years, has become attractive to policy owners. Indeed, the stark difference may seem unfair. Imagine being required by contract to sell your home back to your builder for less than its true market value. No one would agree to that. Similarly, as insureds are becoming more aware of a life settlement secondary market, they are now turning to it to sell their policies rather than back to the original issuing company.

TAXATION OF LIFE SETTLEMENTS AND VIATICALS

If you keep your life insurance policy until your death, the death benefit proceeds of the policy are usually paid to your beneficiaries listed in your life insurance contract free of income tax. If you instead sell your policy to a third party under a life settlement or viatical settlement, that sale will be considered a taxable event. A viatical settlement is one where death is imminent, and historically was used to help people pay for the cost of their medical expenses. A life settlement is a sale of your policy to a third party where death is not imminent.

Since the advent of the life settlement industry, there have been no reported tax court cases or other case law that describe in detail exactly how a life settlement will be taxed. Although there has been one private letter ruling from the Internal Revenue Service, there is still some controversy among tax experts as to how a life settlement will be taxed.

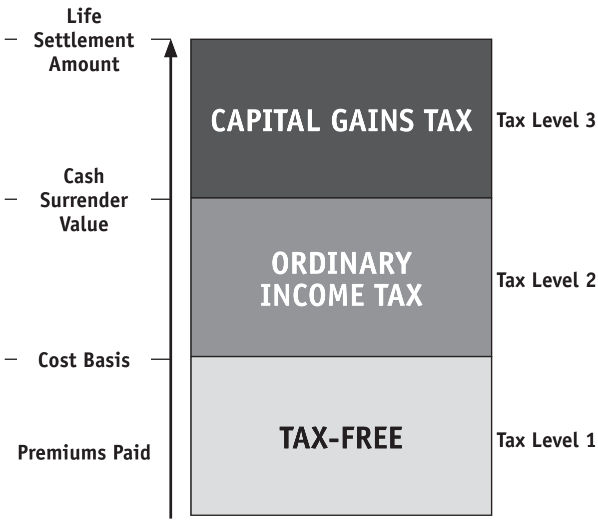
When we speak of taxation in this context, we are generally talking about two types: 1) ordinary income taxation; and 2) capital gains taxation. Ordinary income tax rates are higher than capital gains tax rates. Therefore, if we are to pay taxes on the sale of our policy in a life settlement transaction, we would rather pay capital gains taxes instead of the higher ordinary income taxes.

Most experts agree that taxation of life settlements and viaticals will consist of three component parts. Please refer to the diagram below.

Tax Level 1: The amount you receive up to your adjusted cost basis will be income and capital gain tax free. Your adjusted cost basis is generally the amount of premiums you have paid to date, less certain costs and dividends not included in income.

Tax Level 2: The amount you receive over your adjusted cost basis up to the cash surrender value will be taxed at ordinary income tax rates. Your cash surrender value is that amount your life insurance company would have paid you if you had surrendered your policy to them rather than sold it in a life settlement transaction.

Tax Level 3: The amount you receive in excess of the cash surrender value will be taxed as capital gain.



CONCLUSION

If you find yourself in need of cash, you may wish to consider borrowing or withdrawing cash from your life insurance policy, or, in the alternative, selling your policy on the life settlement market for its true fair market value.

Neil Covert's firm limits its practice to asset protection planning, estate planning, and business planning.