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LIFE SETTLEMENTS: CONGRESS WADES INTO THE FRAY

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Last spring the United States Senate, by voice vote, added a revenue-raising amendment to the House-passed Moving Ahead for Progress in the 21st Century Act (more affectionately known as the "highway bill") that would change a number of tax requirements regarding so-called life settlements. As amended by the Senate, the bill would have (1) imposed tax reporting requirements with respect to life settlements, (2) modified the "transfer for value" rule of section 101(a)(2) in cases of a commercial transfer of a life insurance contract, and (3) reversed a position the Internal Revenue Service ("IRS") took in Rev. Rul. 2009-13[1] regarding how tax basis is determined for a contract involved in a life settlement.[2]

In the congressional "conference committee" process, during which members of the Senate and the House of Representatives negotiated the final contents of the bill, the life settlement provisions were dropped.[3] As a result, the final bill, which President Obama signed into law on July 6, 2012, did not include the Senate amendment (hereinafter, the "Amendment"). Nonetheless, the Amendment was significant, apart from its substance, in three respects: it was sponsored by Sen. Max Baucus (D-MT), who is the chairman of the tax-writing Senate Finance Committee, it was generally supported by both life insurance and life settlement industry trade groups[4] and approved in the Senate without objection, and it would have raised a modest amount of revenue.[5] In view of these characteristics, it seems likely that the proposals in the Amendment could eventually become law as part of some future legislative vehicle.

This article will examine each of the Amendment's three proposals, beginning with a discussion of the background and current status of life settlements in the United States. The article will then explain, in order, the Amendment's proposals relating to reporting for life settlements, the modification of the transfer for value rule for such transactions, and the reversal of the IRS position in Rev. Rul. 2009-13. The article will conclude with an assessment of the anticipated effect of the proposed legislative changes on life insurers.

BACKGROUND AND CURRENT STATUS OF LIFE SETTLEMENTS

In general, a life settlement can be described as a transaction in which a life insurance contract owner sells the contract to a third party, presumably for an amount that exceeds the contract's cash surrender value but is less than the expected death benefit.[6] The ability of a life insurance contract's owner to transfer the contract in a sale transaction was most notably featured in the Supreme Court's 1911 holding in *Grigsby v. Russell*.[7] There, the Court, in an opinion by Justice Oliver Wendell Holmes, Jr., held that life insurance contracts are assets and, as such, are freely assignable.

The AIDS crisis during the 1980s has been cited as the triggering event that sparked the secondary market for life insurance contracts.[8] During the early period of the crisis, AIDs patients needed to pay for the high cost of medical care, and many had a life insurance contract as an asset.[9] Investors were willing to pay AIDs patients an advance on their life insurance death benefits (and more than the contracts' cash surrender values) in exchange for the rights to the contracts' full death benefits.[10] In 1993, the National Association of Insurance Commissioners ("NAIC") adopted the first Viatical Settlement Model Act, to encourage the promulgation of rules that would regulate the sale or transfer of a benefit under a life insurance contract. Several states adopted this Model Act, which some attribute to the development of a secondary market for life insurance contracts, known as the viatical settlement market.[11]

Advancements in the treatment of the AIDS virus and the prolonged life expectancy of individuals with AIDS shifted the focus of this secondary market to seniors who wanted to sell their life insurance contracts.[12] The settlement of life insurance contracts to seniors has become known by the more general term "life settlements," while the term viatical settlements refers to the settlement of contracts insuring the lives of individuals with a life expectancy of less than two years.[13]

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In 2007, the NAIC revised the Viatical Settlement Model Act to address several issues in the life settlement marketplace, including the emergence of a practice known as Stranger-Originated Life Insurance (STOLI).[14] Such STOLI transactions have been defined as life insurance contracts manufactured for the purpose of settling in the secondary market. The life insurance industry has mounted a campaign of opposition to this practice, which it considers a significant abuse.[15]

Recently, there has been a decline in the life settlements market.[16] In 2008, the total face value of life settlement contracts was $12.95 billion. In 2009, however, this number dropped to $7.01 billion.[17] According to a 2011 report, the U.S. life settlement industry saw sales drop about 50 percent in 2012 to roughly $3.8 billion in face value.[18] Some commentators cite, *inter alia*, the recent economic and credit crisis as the reason for this downturn, including the collapse of the subprime mortgage market in 2009 that caused many investors to scale back capital investments.[19] Others have suggested that the downturn in the life settlements market was caused by the nature of the investment required. For example, some have referred to life settlements as a "wasting asset" that requires significant up-front capital to pay premiums of 5-10 percent of face per year and with a possible three-year or more period before any death benefit (*i.e.*, the "return" on the investment) is paid.[20]

Life settlement industry leaders believe that there are still additional challenges facing their industry. Fears that the U.S. economy could fall into a "double-dip" recession have caused investors to hold back capital. Further, as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, federal regulators are debating whether to define life settlement transactions as securities, a proposal that would place them under the jurisdiction of the U.S. Securities and Exchange Commission.[21] Despite these challenges, some believe that the life settlements market may soon be reinvigorated: one recent article estimated that the potential market could reach over $177 billion over the next 10 years due to billions of dollars that retiring (and aging) baby boomers have invested in life insurance contracts.[22]

Insurance companies themselves also have taken steps with their product designs and features to address consumer demand for life settlement options. Due in part to the rising popularity of viatical settlements during the 1980s and 1990s, insurance companies began adding accelerated death benefit riders to life insurance contracts. In 1996, the Health Insurance Portability and Accountability Act added sections 101(g) and 7702B to the Code.[23] In very general terms, those Code sections facilitate favorable tax treatment in cases where the insured under a life insurance contract suffers from a terminal or chronic illness by excluding from gross income (1) benefits paid under the contract before the insured's death, and (2) amounts received in a sale of the contract to a viatical settlement provider. This favorable treatment does not extend to life settlements more generally, however, such as cases where a healthy senior wants to sell his contract to a third party for more than its cash surrender value. In such cases, as discussed below, the sale is generally taxable to the owner under section 1001 and the purchaser generally must include the death benefit in gross income (to the extent it exceeds the consideration paid) pursuant to the "transfer for value rule" of section 101(a)(2).

With regard to this broader life settlements market—and STOLI in particular—the life insurance industry has advocated legislative and regulatory changes to curb perceived abuses. These efforts led the Treasury Department to include in the Obama Administration's fiscal year 2012 budget two proposals regarding life settlements. In its official explanation of the budget proposals (called the "Greenbook"), the Treasury Department observed that "[c]ompliance is sometimes hampered by a lack of information reporting" with respect to life settlements, and that "the current law exceptions to the transfer-for-value rule may give investors the ability to structure a transaction to avoid paying tax on the profit when the insured person dies."[24] In light of these concerns, the Greenbook explained the Treasury Department proposals as (1) requiring information reporting by third-party purchasers of life insurance contracts that provide death benefits of $500,000 or more, and (2) modifying the transfer for value rule to "ensure that exceptions to that rule would not apply to buyers of policies."[25] These proposals would eventually serve as the blueprint for two of those reflected in the Amendment. The Chairman then added the provision reversing the IRS position in Rev. Rul. 2009-13, which went a long way towards ensuring the life settlement industry's support for the Amendment. The Amendment's three proposals are discussed next.

THE AMENDMENT'S PROPOSED REPORTING REQUIREMENTS FOR LIFE SETTLEMENTS

Currently, information reporting is not required in circum-

stances involving the sale of a life insurance contract. The Amendment would have helped close this information gap by requiring reporting for individuals, both buyers and sellers, who engage in a "reportable policy sale." The Amendment defined such a sale as:

> The acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer's interest in such life insurance contract. For purposes of the preceding sentence, the term 'indirectly' applies to the acquisition of an interest in a partnership, trust or other entity that holds an interest in a life insurance contract.

Accordingly, sales of life insurance contracts in the secondary market (*i.e.*, life settlements) would have constituted reportable policy sales under the Amendment.

Under the Code's information reporting rules as modified by the Amendment, if a sale of a life insurance contract were a reportable policy sale, the buyer would have been required to provide certain information in a return filed with the IRS. This information would have included (1) the name, address, and taxpayer identification number (TIN) of the buyer, (2) the name, address, and TIN of each recipient of a payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer of the contract sold and the policy number of such contract, and (5) the amount of each payment.

In addition to filing a return, the buyer would have been required to furnish a written statement to the seller and the life insurance company setting forth (1) the name, address and phone number of the buyer, and (2) the information required to be shown on the return with respect to the seller and the insurer. However, the buyer would not have been required to disclose to the insurer that issued the contract the amount for which the policy was sold—a feature that was necessary to the life settlement industry's support for the Amendment.

The Amendment also included a provision requiring the life insurer that issued the seller's contract to make a return to the IRS reporting the seller's adjusted basis in the life insurance contract. (How one determines such basis is discussed below, in the context of Rev. Rul. 2009-13.) The return would have included (1) the name, address, and TIN of the seller who transfers any interest in the contract, (2) the investment in the contract (as defined in section 72(e)(6)) with respect to the seller, and (3) the policy number of the contract. In addition, the insurer would have needed to provide a written statement to the seller detailing the information that was required to be provided in the return.

Finally, payors of "reportable death benefits" would have been required to file a return setting forth (1) the name, address, and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of the payment, (3) the date of each payment, and (4) the amount of each payment. Under the Amendment, "reportable death benefits" were defined as "amounts paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale." Thus, proceeds payable to the buyer under a life settlement would have been reportable death benefits.

Overall, the proposal provided a reporting regime that would have allowed buyers and sellers to be made aware of the tax consequences of the sale of the life insurance contract, and would have enabled both the IRS and the issuing life insurer to track sales of contracts in the secondary market. The Amendment would have applied to reportable policy sales occurring after Dec. 31, 2012, and to reportable death benefits paid after that date.

THE AMENDMENT'S PROPOSED CHANGES TO THE TRANSFER FOR VALUE RULE

There has been no change in the substance of section 101(a)(2)'s transfer for value rule since 1942. Under that provision in its current (and original) form, when the owner of a life insurance contract transfers some or all of the benefit under the contract (other than in a collateral assignment) to another party *for consideration*, the normal tax-free status of the death proceeds under section 101(a)(1) is precluded and the purchaser of the policy is required to pay income tax on the full amount of the death benefit in excess of the consideration and any premiums that the purchaser paid for the contract. Since 1942, section

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101(a)(2) has provided exceptions to this general rule for certain transfers, *i.e.*, a transfer to the person insured under the contract, to a partner of the insured, or to a partnership or corporation in which the insured is a partner or officer or shareholder, as well as a transfer in which the transferee's cost basis in the contract is calculated by reference to the transferor's basis.

The Amendment proposed to make an exception to these exceptions to the transfer for value rule in the case of "commercial transfers." The Amendment provided as follows:

> (3) EXCEPTION TO VALUABLE CONSIDERATIONRULESFORCOMMERCIAL TRANSFERS.—(A) IN GENERAL.—The second sentence of paragraph (2) shall not apply in the case of a transfer of a life insurance contract, or any interest therein, which is a reportable policy sale.

As described above, a "reportable policy sale" referred to the acquisition of an interest in a life insurance contract, directly or indirectly (including *via* an entity that holds the contract), if the acquirer had no substantial family, business or financial relationship with the insured apart from the acquirer's interest in the life insurance contract. The proposed amendment would have applied to transfers after Dec. 31, 2012.

THE AMENDMENT'S PROPOSED REVERSAL OF THE IRS HOLDING IN REV. RUL. 2009-13

The third and final change that the Amendment would have accomplished was to overrule the IRS position in Rev. Rul. 2009-13 regarding how an individual's tax basis in a life insurance contract is determined upon a sale of the contract. As a general matter, section 72 governs the tax treatment of amounts received under a life insurance contract prior to the insured's death, with such amounts being taxable by reference to the owner's "investment in the contract," as defined in section 72. In contrast, section 1001—regarding the "sale or other disposition of property"—generally governs the tax treatment of amounts received upon the sale of a life insurance contract by its owner to a third party, with such amounts being taxable by reference to the owner's "adjusted basis" in the contract, as defined in section 1011. Because different Code sections apply in these situations, it is possible for different tax results to occur with respect to life settlements (*i.e.*, the sale of a contract) *versus* other policy transactions (*i.e.*, surrenders, withdrawals, and loans).

The IRS made this observation in a pair of 2009 revenue rulings involving life settlements and used it to rationalize disparate treatment of a taxpayer who surrenders *versus* sells his or her contract.[26] In particular, the IRS in Rev. Rul. 2009-13, *Situation 2*, concluded (to the surprise of many) that in the case of an individual who purchased a life insurance contract to provide insurance protection to his or her family, the "adjusted basis" of the contract under section 1011 used to determine gain on the contract's subsequent sale must be reduced by cost of insurance ("COI") charges previously paid under the contract.

In *Situation 2*, taxpayer "A" sold a life insurance contract for $80,000 some eight years after purchasing it to a person unrelated to the taxpayer who would suffer no economic loss on the taxpayer's death, *i.e.*, a party who lacked insurable interest. The contract's cash surrender value at the time of the sale was $78,000, which reflected the addition of interest credits and the subtraction of $10,000 of COI charges that the issuer had previously collected under the contract. Through the date of the sale, A had paid premiums totaling $64,000. The IRS concluded that the seller's adjusted basis in the contract should be reduced by "that portion of the premium paid for the contract that was expended for the provision of insurance before the sale," *i.e.*, the COI charges. In reaching this conclusion, the IRS relied extensively on *dicta* from several cases decided in the 1930s,[27] in addition to citing to (*inter alia*) sections 1011, 1012, and 1016 and the regulations thereunder.

Both the life insurance industry and the life settlement industry disagreed strongly with the IRS' conclusion in *Situation 2*, arguing that it was inconsistent with the general federal income tax treatment of similar transactions in property by individuals. For example, in the case of personal property unrelated to business or investment, the federal tax law generally makes no provision for adjusting the basis of the property to account for personal use or consumption.[28] In determining gain on the sale of such property, the property's basis equals its cost, unadjusted for personal use or consumption.[29] Conversely, where there is a loss on the sale, no deduction is allowed, save in the case of casualty.[30] For these reasons, the ruling's critics argued that a life insurance contract held by or for the benefit of an individual, apart from a business or investment activity, constitutes personal use property, and absent a specific statutory rule dictating a different result, the contract's adjusted basis should be determined in the same manner as adjusted basis in connection with other sales of personal property.[31]

The Amendment appeared to adopt the critics' view of these rules by reversing the IRS conclusion in *Situation 2* of Rev. Rul. 2009-13. The Amendment would have accomplished this by amending section 1016 to specify that there would be no adjustment to the basis of a life insurance contract "for mortality, expense or other reasonable charges incurred under an annuity or life insurance contract." The Amendment's inclusion of this change was a major reason why the life insurance industry and the life settlement industry supported the Amendment. In addition, the Amendment characterized the change as a "clarification" of current law, thereby confirming both industries' longstanding understanding of the manner in which section 1001 and related rules apply to life insurance contracts. Further evidencing the nature of the provision as a clarification rather than a substantive change in law, the Amendment would have applied the provision retroactively to transactions entered into after Aug. 25, 2009, which is the effective date of Rev. Rul. 2009-13.

CONCLUSION

As noted above, President Obama signed the highway bill into law on July 6, 2012, and the Amendment was not included as part of the final bill. Nonetheless, because the Amendment enjoyed broad support, raised some greatly needed revenue, and was not viewed as controversial—recall the voice vote in the Senate—it will likely show up in other legislation in the future. If the Amendment represents the full extent of life insurance-related legislation that passes Congress in 2012 or 2013, it will serve a useful purpose.

END NOTES

1 2009-21 I.R.B. 1029.

2 *See* sections 100112-14 of the Moving Ahead for Progress in the 21st Century Act, H.R. 4348, 112th Cong. (2012), as amended by S.Amdt. 1825 (Mar. 8, 2012). Unless otherwise indicated, our references to "section" or "sections" mean sections of the Internal Revenue Code of 1986, as amended (the "Code").

3 *See* H.R. Rep. No. 112-557 (Conf. Rep.) (2012).

4 The groups that supported the Amendment included the American Council of Life Insurers (ACLI) and the Life Insurance Settlement Association (LISA).

5 The amendment is currently projected to raise $244 million over 10 years. The substance of the amendment was contained in a bill, S.1813, 112th Cong. (2012), previously introduced by Sen. Robert Casey (D-PA).

6 *See* Life Settlements Task Force, Staff Report to the United States Securities and Exchange Commission 3 (2010) (the "SEC Report").

7 222 U.S. 149 (1911). In *Grigsby*, a life insurance policyholder sold his policy to a third party and the seller's estate challenged the purchaser's right to the death benefits after the seller died, on the grounds that the purchaser lacked an insurable interest in the seller's life. In upholding the purchaser's right to the death benefits, Justice Holmes said that "[s]o far as reasonable safety permits, it is desirable to give to life policies the ordinary characteristics of property. To deny the right to sell except to persons having [an insurable interest] is to diminish appreciably the value of the contract in the owner's hands." *Id.* at 156. For more information on the history of life settlements, see Life Insurance Settlement Association, Life Settlement History *available at* http://www.lisa.org/content/51/Life-Settlement-History.aspx (last visited June 14, 2012).

8 *See* SEC Report, supra note 6, at 3; see also U.S. Gov't Accountability Office, GAO-10-775, Report to the Special Committee on Aging, U.S. Senate, Life Insurance Settlements: Regulatory Inconsistencies May Pose a Number of Challenges 8 (2010) (the "GAO Report").

9 *See* SEC Report, *supra* note 6, at 3.

10 *Id.*

11 *Id.*

12 *Id.*

13 Charles Delafuente, *When Life Insurance is More Valuable as Cash, N.Y. Times (Mar. 3, 2010), http://www.nytimes.com/2010/03/04/business/retirementspecial/04LIFE.html.*

14 *See* NAIC News Release, NAIC Adopts Viatical Settlements Model Act Revisions (June 4, 2007) available at http://www.naic.org/Releases/2007_docs/viatical_settlements_model.htm.

15 *See, e.g.,* Letter of American Council of Life Insurers addressed to Mary L. Shapiro, Chairwoman of the U.S. Securities and Exchange Commission (Oct. 6, 2011) available at *http://www.acli.com/Issues/Pages/CT11-133.aspx* (urging the SEC to adopt recommendations to curb STOLI).

16 *See* SEC Report, *supra* note 6, at 3.

17 GAO Report, *supra* note 8, at 8.

18 Fran Matso Lysiak, *Conning: Life Settlement Sales Drop About 50% in 2010; Investors Focused on 'Distressed' Portfolios,* Best's News Service (Oct. 6, 2011).

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END NOTES CONT.

19 Goldman Sachs, a major player in the life settlements market, exited the market in 2010, and Deutsche Bank, another industry leader, had earlier downsized its operations in the market. *See* SEC Report, *supra* note 6, at 4; *see also* Jeff Jeffrey, *Life Settlement Industry Sees Signs of Growth, but Questions Remain,* Best's News Service (Aug. 8, 2011).

20 SEC Report, *supra* note 6, at 4.

21 *See* Jeffrey, *supra* note 19; SEC Report, *supra* note 6, at 39.

22 Jeff Jeffrey, *Betty White Ad Signals Attempt by Life Settlement Industry to Buck Their Niche Status,* Best's News Service (Feb. 21, 2012).

23 Pub. L. No. 104-191 (1996).

24 U.S. Dep't of Treasury, General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals 51 (2011).

25 *Id.*

26 Rev. Rul. 2009-13, 2009-21 I.R.B. 1029; Rev. Rul. 2009-14, 2009-21 I.R.B. 1031.

27 London Shoe Co. v. Comm'r, 80 F.2d 230 (2d Cir. 1935) (involving the deductibility of a loss on surrender); Century Wood Preserving Co. v. Comm'r, 69 F.2d 967 (3d Cir. 1934) (involving the deductibility of a loss on sale); Keystone Consolidated Pub. Co. v. Comm'r, 26 B.T.A. 1210 (1932) (involving the deductibility of a loss on sale).

28 *See* section 1016.

29 *See* section 1001.

30 *Id.*; *see also* section 165.

31 For a more complete understanding of the opposing view, *see* Letter of American Council of Life Insurers addressed to Jeffrey Van Hove, Tax Legislative Counsel, Office of Tax Policy, Treasury Department, Mark S. Smith, Attorney-Advisor, Office of Tax Policy, Treasury Department, Sheryl Flum, Branch Chief, Branch 4, Office of Associate Chief Counsel, FIP, Internal Revenue Service on *Rev. Rul. 2009-13* (Apr. 20, 2011).