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*By Lucas Siegel.*

As record-high inflation saps wealth and purchasing power, your high-net-worth clients may be interested in strategies to restructure their finances. For some, that restructure could involve liquidating life insurance via a [life settlement](#), which would come with tax implications.

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Life settlement proceeds above the cost basis are taxable in two tiers:

1. Proceeds over the cost basis and up to the policy's cash surrender value are taxed as ordinary income.
2. Proceeds over and above the policy's cash surrender value are taxed as long-term capital gains.

Consider a policy that sells for \$110,000. If the policyholder paid \$50,000 in cumulative premiums, the total taxable gain is \$60,000. Assuming a cash surrender value of \$55,000, \$5,000 of the \$60,000 gain is taxable at the policyholder's income tax rate. The IRS treats the rest of the gain — \$55,000 — as a long-term capital gain.

### **State taxation of life settlements**

Selling policyholders may also owe state taxes in their home state. Each state's tax treatment of life settlements aligns with the state's general approach to income and capital gains taxes. There are three scenarios:

1. In states that don't collect taxes on income or investment gains, policyholders will only pay federal taxes on life settlement proceeds.
2. In states that don't offer a lower capital gains rate, the policyholder's state income tax rate will apply to the entire taxable gain, or net proceeds less cumulative premiums.
3. In states that have their own rules for capital gains, policyholders would first calculate the two tiers of gains as dictated by TCJA. The state's income rate would apply to the income portion of the proceeds, and the state's normal capital gains rules would apply to the rest.

### **After-tax, proceeds exceed the cash value**

Regardless of where the policyholder lives, the after-tax proceeds from a life

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settlements or the income tax and capital gains tax rates. While the Biden administration pitched big tax rate increases on high-income individuals in the 2021 American Families Plan, there hasn't been sufficient congressional support for that effort to date.

For now, policyholders can consider the life settlement as a strategy to maximize the value of their life insurance. Even though the gain on the transaction is taxable, the net proceeds will be [more than the policy's cash surrender value](#). A seasoned tax professional can assess how the additional gain will affect the policyholder's overall tax burden for the year.

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*About: Lucas Siegel is the founder and CEO of [Harbor Life Settlements](#), a life settlement company that is dedicated to helping seniors and the terminally ill sell their life insurance policies, and [Harbor Life Brokerage](#), a life settlement broker.*

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