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From: stevesletters@leimbergservices.com**Sent:** Monday, May 04, 2009 10:00 AM**To:** Smith, G. Pearson**Subject:** FLASH - Rev. Rulings 2009-13 and 2009-14 – Income Tax Consequences of Surrender and Sale of Life Insurance Contract Steve Leimberg's Estate Planning Newsletter**Steve Leimberg's Estate Planning Email Newsletter - Archive Message #1457****Date:** 04-May-09**From:** Steve Leimberg's Estate Planning Newsletter**Subject:** **FLASH - Rev. Rulings 2009-13 and 2009-14 – Income Tax Consequences of Surrender and Sale of Life Insurance Contract**

At long last, the Treasury and IRS have issued much needed guidance on a variety of tax issues confronting sellers and buyers of life insurance policies in the secondary market. In this important commentary, **Howard Zaritsky** and I will take **LISI** members through a detailed analysis of Revenue Rulings 2009-13 and 2009-14.

These are such important explanations that we've also asked **LISI** Commentator Team Members **Larry Brody** and **Jonathan Blattmachr** to provide us with additional newsletters on this topic. You'll hear from them later this week.

Howard Zaritsky, author of [Tax Planning With Life Insurance: Analysis and Forms 2nd Edition](#), (800 950 1216) is well-known to **LISI** members. He has been a lecturer at major tax and estate planning institutes, including the New York University Institute on Federal Taxation and the University of Miami (Heckerling) Estate Planning Institute where he is a member of the advisory committee. Howard is the author or co-author of numerous articles and treatises, including Generation-Skipping Transfer Taxes: Analysis and Forms (with C. Harrington & L. Plaine); Structuring Buy-Sell Agreements (2d ed); Structuring Estate Freezes After Chapter 14 (3d ed.) (with R. Aucutt); Federal Income Taxation of Estates and Trusts (2d ed.) (with N. Lane); Tax Planning for Family Wealth Transfers (3d ed.); [all published by RIA Group].

Here is our commentary on these two important Rulings.

EXECUTIVE SUMMARY:

In two revenue rulings, the IRS detailed the income tax consequences of

1. the *surrender* of a life insurance policy by the insured for its cash surrender value,
2. the *sale* of a cash value life insurance policy by the insured to an unrelated third-party for a cash payment,
3. the *sale* of a *term* life insurance policy by the insured to an unrelated third party for a cash payment,
4. the *receipt* of *death benefits* by a third-party who purchases an insurance policy from the insured,
5. the *resale* of a life insurance policy by the third-party who bought it from the insured, and
6. the *receipt* of death benefits by a *foreign* third-party who purchases from a U.S. insured an insurance policy issued by a U.S. insurer .

FACTS:

REVENUE RULING 2009-13. TAXING THE TRANSFEROR.

Revenue Ruling 2009-13 addresses the surrender or sale of a life insurance policy to a person who lacks an insurable interest in the policy.

This ruling provides three hypothetical situations and discusses the results of each.

SITUATION 1: (SURRENDER OF POLICY)

In Situation 1, the taxpayer, A, is a cash method, calendar year individual who bought an insurance contract on A's own life. The policy had cash values and the named beneficiary was a member of A's family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value.

A paid \$64,000 in premiums in Years 1-8, and on June 15 of Year 8, surrendered the contract to the issuer for \$78,000, the cash surrender

value of the policy. The cash surrender value *reflected* a \$10,000 subtraction for the "cost-of-insurance" charges collected by the issuer for periods ending on or before the surrender of the contract.

At no time did A receive any distributions under the contract or borrow against the cash surrender value.

The IRS said that A had received \$14,000 of ordinary income on the surrender of the policy. The IRS applied Section 72(e), which expressly governs amounts received on the complete surrender of a non-annuity life insurance contract.

Section 72(e)(5)(A) says that any non-annuity amount received on the complete surrender of a life insurance contract is includible in the owner's gross income, to the extent that it exceeds the owner's investment in the contract.

The owner's investment in the contract in the case of a complete surrender is the total of all of the premiums or other consideration paid for the contract, minus all amounts received under the contract to the extent otherwise excludable from gross income.

Therefore, the IRS said, because A received \$78,000 on the surrender of the policy, A must include in gross income the excess of \$78,000 over A's \$64,000 investment in the contract. This leaves A with a \$14,000 gain on the surrender.

The IRS also said that the entire gain was taxable as ordinary income. The policy *was* a capital asset to A, but because there was no sale or exchange of the policy, the gain had to be ordinary income.

(1) Cash Surrender Value	\$78,000
(2) <i>Less</i> Premiums Paid	\$64,000
(3) <i>Equals</i> Gain	\$14,000 [(1) – (2)]
Character:	Ordinary Income

SITUATION 2: (SALE OF CASH VALUE POLICY)

In Situation 2, the facts were the same as those in Situation 1, except that A *sold* the contract for \$80,000 to B. B was not related to A and B would suffer no economic loss on A's death. In other words, this is the classic life settlement situation although it could also apply to a transaction where the buyer was not a life settlement company but was unrelated in any way to the seller.

The IRS noted first that Section 72 does *not* apply to amounts received on the sale of a life insurance policy. Therefore, the IRS had to look to general income tax rules. The IRS said that A had a taxable gain on the sale equal to the amount A received as the sales price (the amount realized), minus A's basis in the insurance contract.

The amount A received was \$80,000.

A's basis in the insurance contract was the \$64,000 premiums that A had paid, *minus* any expenditures, receipts, losses, or other items properly chargeable to capital account, and *minus* the cost of the pure life insurance protection during A's ownership of the policy.

In Situation 2, A had to *reduce* the basis of the contract by the \$10,000 cost-of-insurance charge assumed here – bringing A's adjusted basis down to \$54,000. This left A with a \$26,000 taxable gain (\$80,000 amount realized - \$54,000 adjusted basis).

The IRS then said that the gain was partially ordinary income and partially capital gain. The policy was a capital asset and there *was* a sale or exchange and the policy was held the requisite "long term" period. But the IRS *still* treated part of the gain as ordinary income, under the judicial "substitute for ordinary income doctrine."

This doctrine converts capital gains into ordinary income where the asset being sold is itself properly attributable to income.

The IRS noted that this doctrine has been applied to characterize the profit on a sale of an annuity contract or life insurance contract as

ordinary income, but said that the application of this doctrine is *limited* to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., to the inside build-up under the contract).

Therefore, capital gains treatment is afforded any amount recognized on the sale or exchange of a life insurance policy to the extent that it *exceeds* the "inside build-up" under the contract.

In Situation 2, the IRS stated that the inside build-up under A's life insurance contract immediately prior to the sale was \$14,000 (\$78,000 cash surrender value less \$64,000 aggregate premiums paid).

Therefore, A had \$14,000 of ordinary income and \$12,000 of capital gain.

(1) Amount Realized (Sales Proceeds)	\$80,000
(2) Cash Surrender Value	\$78,000
(3) Premiums Paid (Basis)	\$64,000
(4) <i>Less</i> Cost of Insurance	\$10,000
(5) Equals Adjusted Basis	\$54,000 [(3)-(4)]
(6) Gain	\$26,000 [(1)-(5)]
(7) <i>Less</i> Ordinary Income Portion of Gain	\$14,000 [(2)-(3)]
(8) Equals Capital Gain Portion	\$12,000 [(6)-(7)]

SITUATION 3: (SALE OF TERM POLICY)

The facts in Situation 3 were identical to those in Situation 1, except that the contract was a level premium fifteen-year term life insurance contract with no cash surrender value. The monthly premium was \$500, and A paid a total of \$45,000 in premiums through the June 15, Year 8 sales date.

In Situation 3, A sold the policy for \$20,000.

The IRS said that A realized \$20,000 on the sale, and that A's adjusted basis was equal to the total premiums paid under the contract, *less* the charges for the provision of pre-sale life insurance protection.

Where there is no other proof, the IRS said, the cost of the pure life insurance protection would be presumed to be equal to the *entire* premium paid.

Therefore, \$44,750 of A's premiums was paid for pure life insurance protection and A's basis was only \$250. A had a \$19,750 gain on the sale, which was a capital gain, because there was no cash surrender value and the substitute for income doctrine could not apply.

(1) Amount Realized on Sale	\$20,000
(2) Premiums Paid (Basis)	\$45,000
(3) <i>Less</i> Cost of Insurance	\$44,750
(4) Equals Adjusted Basis	\$250 [(2) – (3)]
(5) Gain	\$19,750 [(1) – (4)]
(6) Character:	Capital Gain

SUMMARY:

Thus, in summary, Revenue Ruling 2009-13 states that:

1. Upon the *surrender* of a cash value contract, the taxpayer's gain is the difference between the amount realized in the sale and the seller's adjusted basis (investment in the contract).
2. Upon the *surrender* of a cash value contract, the IRS *assumes* that cash surrender value reflects the subtraction of "cost-of-insurance" charges collected by the issuer for periods ending on or before the surrender of the contract.

3. No capital gains treatment will be allowed on the surrender of a contract and any realized gain is taxable as ordinary income.
4. Upon the *sale* of a cash value policy, the recognized gain is the difference between the amount realized (the amount paid for the contract) and the policy owner's adjusted basis, and the basis is determined by subtracting from the total premiums paid the cost of the insurance for the pre-sale period.
5. Upon the *sale* of a *cash value* policy, any recognized gain up to the policy's cash surrender value will be taxed as *ordinary* income.
6. Upon the *sale* of a *cash value* policy, any recognized gain *above* the policy's cash surrender value will be taxed as a capital gain.
7. Upon the *sale* of a *term* policy, the amount realized is the amount received on the sale, and the adjusted basis is usually *only* the unexpired portion of the last premium (the difference between the premiums paid and the cost of the pre-sale insurance coverage).
8. Upon the *sale* of a *term* policy, any gain will be taxed as a *capital gain*.

REVENUE RULING 2009-14. TAXING THE TRANSFEREE.

Revenue Ruling 2009-14 explained the income tax consequences to the life settlement company or individual who *bought* A's life insurance policy, when A died or the buyer *resold* the policy.

Revenue Ruling 2009-14 also was divided into three different fact patterns.

SITUATION 1: (INSURED DIES – PROCEEDS PAID TO 3RD PARTY TRANSFEREE)

In Situation 1, A sold the life insurance policy to B, a cash basis, calendar year, U.S. taxpayer. The sales date was June 15, 2008, and

the purchase price was \$20,000. The policy was a 15-year, level premium term life insurance policy with no cash surrender value.

B bought the policy when A still had slightly more than half of the 15-year period left to run. A had been paying \$500 per month in premiums, and they were due on the first of each month. B had no insurable interest in A's life and it bought the contract with a view to profit, promptly naming itself beneficiary after the purchase.

B continued to pay the premiums after buying the policy.

After B had paid \$9,000 in additional premiums, on December 31, 2009, A died and the insurer paid B \$100,000 in death benefits.

The IRS said that B had \$71,000 of ordinary income from the \$100,000 death benefit.

The IRS explained that life insurance death benefits are not *normally* includible in gross income, but that they *are* taxable if the policy was acquired in a transfer for value.

The death benefits paid on a policy that was acquired in a transfer for value are taxable, except to the extent of the sum of:

1. the consideration paid to buy the policy; and
2. the premiums and other amounts subsequently paid by the transferee.

There are four "safe harbor" exceptions to the transfer for value rule, but the IRS explained that *none* of these applied here. Therefore, B can exclude from gross income only the \$20,000 B paid for the policy and the \$9,000 of premiums B paid after the sale.

The IRS stated that B's gain was ordinary income, because the receipt of the death benefit was not a "sale or exchange" and capital gains treatment is available only for gains realized on a sale or exchange of a capital asset.

SITUATION 2: (RESALE OF CONTRACT BY 1ST BUYER)

Situation 2 assumed the same facts as in Situation 1, except that on December 31, 2009, while A was still alive, B resold the policy to C,

a person (or investor group) unrelated to A or B, for \$30,000. The IRS said that B had a \$1,000 capital gain on this sale, because B had realized \$30,000 on the sale, and B's basis in the policy included both the \$20,000 B paid A to sell the policy and the \$9,000 in premiums B paid after its purchase.

The IRS stated that B did *not* have to reduce its basis in the policy for the cost of the pure life insurance coverage, because B did not benefit from that coverage. The IRS stressed that B is wholly unrelated to A, the policy was not bought to protect B against any economic loss upon A's death, B bought the policy solely with a view to profit, and the additional premiums were paid solely to prevent the loss of B's financial investment.

The IRS said that B's gain on the resale is a capital gain, because the policy was a capital asset in the hands of B and the gain was realized on a sale or exchange (and because the policy was held the requisite period of time).

The substitute for ordinary income doctrine will not apply, because the contract was a term contract with no cash value.

Presumably, had the policy been a cash value policy, part of the gain might have been ordinary income under the substitute for income doctrine, discussed in Revenue Ruling 2009-13.

(The use of a term policy in this IRS illustration is puzzling since most policies purchased by life settlement companies are cash value types rather than term.)

SITUATION 3: (SALE BY FOREIGN CORPORATION):

Situation 3 had the same facts as were identical to those in Situation 1, except that B was a foreign corporation not engaged in a trade or business within the United States. The IRS stated that B had \$71,000 of taxable income on the receipt of the \$100,000 death benefit (\$100,000 - \$20,000 - \$9,000), and that this amount is subject to U.S. income taxes.

The IRS said that this income was "fixed or determinable annual or periodical" income and that B was subject to U.S. income taxes, because the income was from U.S. sources. The IRS said that the Code does not specify the source of income from a term life

insurance contract death benefit, but that comparison and analogy to classes of income that are specified within the statute, this appeared to be U.S. source income. The IRS stressed that the insured was a U.S. citizen residing in the United States and that the insurer was a domestic corporation.

SUMMARY:

Thus, in summary, under Revenue Ruling 2009-14:

1. When a policy is sold to a transferee for value, the gain is found by subtracting from the death benefit received the sum of the amount paid for the policy and premiums paid after the purchase, and this gain is taxed as ordinary income.
2. When a policy is bought by a transferee for value and held for profit, upon a later sale of the policy to a third party, any gain will be the excess of the amount realized on the sale over the seller's adjusted basis (amount paid for the policy plus premiums paid after the purchase) – undiminished by the cost of insurance.
3. When a term policy is bought by a transferee for value and held for profit, upon a later sale of the policy to a third party, any gain will be taxed as a long-term capital gain (assuming the requisite holding period).
4. When a cash value policy is bought by a transferee for value and held for profit, upon a later sale of the policy to a third party, any gain up to the policy's cash surrender value will be taxed as ordinary income.
5. Generally, when the purchaser of an existing life insurance policy is a foreign corporation, gain on the receipt of the death benefits will be the excess of the death benefit received over the sum of the amount paid for the policy and the premiums paid after the purchase.
6. When the purchaser of an existing life insurance policy is a foreign corporation, any gain on the receipt of the death benefits will be taxable as U.S. source income if the insured and the insurer are both U.S. persons.

COMMENT:

The IRS has been very slow in addressing the income tax consequences of transactions in the life settlement market. This has led promoters of stranger-owned life insurance (SOLI) arrangements to represent to the selling insureds that they would have little or no taxable gain on their transfers of policies, and to their own investors that they would have little taxable income on the profits from these policy purchases.

The issuance of Revenue Ruling 2009-13 and Revenue Ruling 2009-14, which detail the income tax consequences of the sale and purchase of a life insurance policy by a person who does not have an insurable interest in the life of the insured, and the receipt of insurance proceeds on such policies by the purchasers, makes the basis and many other issues clear.

Revenue Rulings 2009-13 and 2009-14 may have a chilling effect on the life settlement industry. Life settlement companies and other third-party buyers of existing life insurance contracts have generally promoted the notion that the insured-seller's adjusted basis in the contract would be based on the *aggregate* premiums paid, rather than the cash surrender value, and that accordingly, little gain would be recognized on the sale.

Now, sellers are on notice that their basis in a term policy will be only the unexpired portion of the most recent premium.

Revenue rulings are generally retroactive, unless the IRS says otherwise. However, Revenue Ruling 2009-13 says that "the holdings of this revenue ruling with respect to Situations 2 and 3 will not be applied adversely to sales occurring before August 26, 2009."

Revenue Ruling 2009-14 contains no such representation, and so *will* be applied retroactively.

It is also interesting that neither ruling discusses the requirements for tax reporting; it seems likely that additional reporting and withholding guidance will be forthcoming.

Note also that the IRS did not address the method of calculating cost of insurance – except in the case of a term policy.

Our thanks to **Lee Slavutin** and **Steve Sternberger** who provided helpful input.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A
POSITIVE DIFFERENCE!**

Steve Leimberg
Howard Zaritsky

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CITES:

Rev. Rul. 2009-13 and Rev. Rul. 2009-14; Int. Rev. Code §§ 101, 881, 1001, 1011, 1016, 7805; London Shoe Co. v. Comm'r, 80 F.2d 230, 231 (2d Cir. 1935), cert. denied 298 US 663 (1936); Century Wood Preserving Co. v. Comm'r, 69 F.2d 967, 968 (3d Cir. 1934); Keystone Consolidated Publishing Co. v. Comm'r, 26 B.T.A. 1210, 1211 (1932); U.S. v. Midland-Ross Corp., 381 US 54, 57 (1965); Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958); Arkansas Best Corp. v. Commissioner, 485 US 212, 217, n.5 (1988); Prebola v. Commissioner, 482 F.3d 610 (2d Cir. 2007); U.S. v. Maginnis, 356 F.3d 1179 (9th Cir. 2004); Davis v. Comm'r, 119 T.C. 1 (2002); Rev. Rul. 64-51, 1964-1 C.B. 322; Rev. Rul. 2004-75, 2004-1 C.B. 516.

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