IRS Issues Guidance on Sales of Insurance Policies (and Related Transactions)

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In recent years, a large industry has developed around investor acquisitions of life insurance contracts. The tax ramifications (and other considerations) concerning such "stranger owned life insurance" (SOLI) have been much debated, but were unclear. On May 1, 2009, the IRS issued Revenue Rulings 2009-13 and 2009-14 that discuss tax issues for, respectively, the owner/insured who sells a life insurance contract and the investor who purchases a life insurance contract. The two Rulings use relatively parallel examples, but do leave some gaps to fill in by extrapolation. More significantly, the IRS position leads to an anomalous tax result to the owner/insured based on whether a policy is surrendered or sold.

The assumed facts common throughout most of the Rulings are that:

"A" is a US citizen residing in the US who owns a "life insurance contract" as defined in IRC §7702 on his own life issued on January 1 of Year 1.

"B" is a US person as defined in IRC §7701(a)(30).

A and B each determine taxable income using the cash method of accounting and file income tax returns on a calendar year basis.

The life insurance contract is in the face amount of $100,000. As of June 15 of Year 8, the policy has a cash surrender value (CSV) of $78,000 and A has paid a total of $64,000 in premiums. The "cost-of-insurance" charges collected by the insurer are $10,000.

A has not borrowed against the policy or received any distributions under it.

As of June 15 of Year 8, A was not a "terminally ill individual" or a "chronically ill individual" as such terms are defined in IRC §101(g)(4).

Finally, to the extent it otherwise qualifies as a "capital asset," the insurance contract in A's hands or B's hands is not excluded from the definition of "capital asset" under the provisions of IRC §1221(a)(1)-(8).

The anomalous result mentioned above derives from the distinction between the specific statutory provisions that apply upon the death of an insured versus the basic rules that apply upon the sale of an asset.

IRC §72(e)(5) provides that for life insurance contracts such as the one in the examples, proceeds received are included in gross income "to the extent it exceeds the investment in the contract." IRC §72(e)(6) defines the "investment in the contract" as "(A) the aggregate amount of premiums or other consideration paid for the contract before such date, minus (B) the aggregate amount received under the contract before such date, to the extent that such amount was excludable from gross income under this subtitle or prior income tax laws." The component of premiums that represents "cost-of-insurance" is not included in this statutory definition.

On the other hand, under IRC §1001(a) "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain." IRC §1011 provides that "adjusted basis" is typically the basis under IRC §1012 adjusted as provided in IRC §1016. Under IRC §1016(a)(1), adjustment is to be made "for expenditures, receipts, losses, or other items, properly chargeable to capital account." As discussed below, the IRS concludes that A's adjusted basis in the policy is determined by subtracting the "cost-of-insurance" since that is an expense "properly chargeable to capital account."

With this background, we can examine the specific situations discussed in the Revenue Rulings. For each example, the IRS first analyzes the amount realized and recognized in the transaction and then the character of that amount as ordinary income or long term capital gain.

Rev Rul 2009-13, Situation 1 addresses the simple surrender of the policy in consideration of the CSV. The amount received is $78,000 and the "investment in the contract" is $64,000 so that the amount recognized as income is $14,000. While the IRS notes that the contract is a "capital asset," the Ruling states that "the surrender of a life insurance contract does not, however, produce a capital gain." The presumed basis for this statement is that surrender is not a "sale or other disposition" under IRC §1001(a). Accordingly, the IRS concludes that the $14,000 in recognized income is taxable as ordinary income.

In concluding that capital gains treatment does not apply, the IRS states that §1234A, which provides capital gains treatment to "the cancellation, lapse, expiration, or other termination" of certain rights or obligations "does not change this result." While not cited in Rev Rul 2009-13, this conclusion follows TAM 200452033.

Rev Rul 2009-13, Situation 2 addresses the sale of the policy by A to B for $80,000. However, to highlight the anomaly in the Ruling, I would like to change this to $78,000; the same amount as the CSV received in Situation 1.

The amount realized is $78,000 and the adjusted basis is $54,000 (the $64,000 paid less the $10,000 "cost-of-insurance" that benefitted A as other than an investment) for an amount recognized of $24,000. While this transaction is clearly the sale of a capital asset permitting long term capital gain treatment, the IRS then applies the "substitute for ordinary income doctrine" to hold that the amount that would be ordinary income were the policy simply surrendered should still be ordinary income on the sale.

Thus, the $24,000 recognized is taxed as $14,000 of ordinary income and $10,000 of long term capital gain. Note, that A's receipt of the same $78,000 in Situation 1 and Situation 2 (as I have modified it) has produced a completely different result based on whether the policy was surrendered or sold.

Rev Rul 2009-13, Situation 3 changes the assumed facts to provide for A to sell a term life insurance contract that has a premium cost of $500 per month. The policy has no CSV and is sold for $20,000. A has paid $45,000 in premiums over 90 months, but because the sale takes place on June 15 of Year 8, there is one half month ($250) that represents premium paid for insurance coverage not received by A.[1] This is allowed as A's adjusted basis. Hence, on the sale, A recognizes $19,750.

Because there is no amount that is a "substitute for ordinary income," the entire $19,750 is treated as long term capital gain.

Rev Rul 2009-14, in looking at consequences to B, assumes only a term life insurance contract with no CSV (that is, Situation 3 from Rev Rul 2009-13), but it is possible to extrapolate how the IRS might analyze a situation involving CSV. After acquiring the policy from A for $20,000 on June 15 of Year 8, the IRS assumes that B holds it until December 31 of Year 9 having paid 18 months of premiums at $500 per month.

In **Rev Rul 2009-14, Situation 1**, A dies on December 31 of Year 9 and B collects $100,000. IRC §101(a)(1) generally provides that "gross income does not include amounts received … under a life insurance contract, if such amounts are paid by reason of the death of the insured." However, IRC §101(a)(2) contains an exception that where there has been a "transfer for a valuable consideration … the amount excluded from gross income by paragraph (1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and other amounts subsequently paid by the transferee."

Accordingly, B can exclude only $29,000 from gross income and must recognize $71,000. While the policy is a "capital asset," the IRS concludes that the receipt of the death benefit under a life insurance contract does not produce a capital gain. The $71,000 recognized is taxed to B as ordinary income.

Since the entire amount recognized is ordinary income, there is no need to extrapolate to a policy with CSV. That would also produce only ordinary income.

In **Rev Rul 2009-14, Situation 2**, B sells the policy for $30,000. B's adjusted basis in the policy is the full amount paid, including premiums, $29,000. Unlike in Situation 2 of Rev Rul 2009-13, there is no subtraction for the cost of insurance coverage obtained because B is holding the policy "solely with a view to profit" and not for the insurance protection that had been available to A. Accordingly, the amount recognized is $1,000.

Further, since this is a sale of a capital asset, the $1,000 recognized is taxable to B as long term capital gain.

In reaching this conclusion, the IRS notes that "the contract was a term contract without any cash value. Hence the substitute for ordinary income doctrine … does not apply." This strongly suggests that, if B had purchased from A a policy with CSV and surrendered it for the CSV, then the IRS would conclude that the surrender produces ordinary income to B. Following that logic means that if B resold the policy after purchasing it from A, the sale would produce ordinary income to the extent B would have ordinary income on surrender and capital gains for any excess.

Note that in Situation 1 and Situation 2, the IRS does not address borrowings to acquire or maintain the policies or policy loans and whether or not B could include interest charges in basis. Under IRC §264(a)(4), B would not be allowed to deduct interest costs as an expense.

Finally, **Rev Rul 2009-14, Situation 3**, changes the assumed facts from Situation 1 to provide that B is a foreign corporation. The same recognized amount of $71,000 is at issue. Pursuant to IRC §881(a)(1) this recognized amount is "fixed or determinable annual or periodical … income" and is taxable if "received from sources within the United States." For purposes of that issue, in addition to the assumed facts described at the start of this article, the IRS assumes that the policy was issued by an insurer that is a domestic corporation. On this basis, because A is a US citizen residing in the US and the insurer is a domestic corporation, the IRS concludes that the death benefits are US sourced. As in Situation 1, the $71,000 recognized is taxed as ordinary income.

In conclusion, Revenue Rulings 2009-13 and 2009-14 provide much needed guidance to persons interested in selling or purchasing life insurance contracts. In deciding between alternatives, it is important to consider the resulting basis determination and character of income. Since different structures will have different results, planning opportunities may exist. For the seller, the basis difference between surrendering and selling a policy may make surrender the more attractive alternative, even for a lower amount. For the buyer, the fact that proceeds upon the death of the insured will result entirely in ordinary income while sales proceeds should result at least partially in capital gains may make a sale more attractive than holding a policy.

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[1] The IRS analysis actually reaches this conclusion from the opposite direction. A has paid $45,000 in premiums, and his basis is that amount less the cost of insurance he has received. Since the IRS assumes that the value of the insurance is the contract amount of $500 per month and A held the contract for 89.5 months, the amount to subtract is $44,750. The IRS uses this backward approach to leave open the possibility that the assumption may not hold in every circumstance. In fact, the Ruling states that the assumption applies "[a]bsent other proof."