

New IRS Revenue Rulings: Amount and Character of Income on Life Insurance Contracts

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On May 1, 2009, the IRS issued a pair of Revenue Rulings that significantly clarify the state of U.S. federal tax law applicable to transactions involving life insurance policies, including life settlements. Life settlements are a rapidly growing asset category in which investors purchase life insurance policies on the secondary market with the intention of profiting by either reselling them later for a gain or holding them until maturity. One of the impediments to the development of this asset class has been the uncertainty of the U.S. federal income taxation in this area because most of the cases and rulings predate the development of an active secondary market for life insurance policies.

This **Stroock Special Bulletin** highlights some of the ways in which the IRS Revenue Rulings are an improvement over the prior state of law, and discusses some important issues that remain and additional questions the Revenue Rulings raise. The holdings of the Revenue Ruling relating to reductions of basis in the hands of the insured for the cost of insurance protection will not be applied to sales occurring before August 26, 2009.

Revenue Ruling 2009-13: Tax Consequences to the Original Holder of a Life Insurance Contract

In Revenue Ruling 2009-13, the IRS concludes that under Section 72¹ the original holder of a life insurance contract (the “Insured”) who surrenders the contract for its cash surrender value recognizes ordinary income. The amount of the income is reduced by the sum of all premiums paid under the policy.

The Revenue Ruling goes on to contrast a surrender of a life insurance policy with a sale of the policy on the secondary market. The amount of the gain on a secondary sale is greater because the IRS concluded that the basis of the life insurance contract should be reduced by the amount expended for the cost of mortality protection before the sale.

Additionally, the IRS held that the character of the income in a secondary sale is bifurcated. A portion of the gain, up to the amount of ordinary income that would result from a surrender of the policy, is treated as ordinary income, with the balance of the gain, if any, treated as either

long-term or short-term capital gain, depending on the holding period. In the case of a term-life insurance policy, the IRS assumed that absent other proof, the entire premium is used for current insurance protection and thus does not create basis in the policy. Thus, when a term-life insurance contract is sold, the entire amount of the sale proceeds generally will be taxable as capital gain.

Revenue Ruling 2009-14: The Tax Consequences to the Person who Purchases a Term-life Insurance Contract on the Secondary Market

Revenue Ruling 2009-14 describes the U.S. federal income tax consequences to the person who purchases a term-life insurance contract on the secondary market (the “Secondary Purchaser”) upon the receipt of death benefits, or upon the receipt of sale proceeds, with regard to a term-life insurance contract that the Secondary Purchaser sells for profit.

The IRS held that on maturity of the life insurance policy, the Secondary Purchaser is required to recognize as income the difference between (1) the total death benefit received and (2) the amount of actual value of the consideration paid for the purchase plus the monthly premiums paid by the Secondary Purchaser. The entire amount of the income is treated as ordinary income.

The Revenue Ruling also held that if the Secondary Purchaser sells the term-life insurance contract to an unrelated party, the entire amount of gain is capital gain. The amount of the gain realized is the excess of the amount realized over the adjusted basis. The adjusted basis is computed as the amount paid to acquire the life insurance contract plus the monthly premiums that were paid to prevent the contract from lapsing. As described below,

because this ruling only applies to term-life contracts, it is unclear if the IRS would allow capitalization (or capital gain treatment) of the entire premium for contracts with cash surrender value.

The IRS also held that the death benefit of a life insurance policy written by a U.S. insurance company on the life of a U.S. person is U.S. source income. The IRS ruled that the Secondary Purchaser must recognize ordinary income from sources within the United States, and tax is imposed under Section 881(a)(1) (withholding tax) with respect to this amount.

Issues Raised by the Revenue Rulings Basis

The reduction of basis for the “cost of insurance” for policies sold by the Insured is inconsistent with some IRS guidance and several court decisions.² The IRS also does not cite any statutory basis in support of its position.

The three dated cases cited by the IRS in support of the basis reduction³ involved sales for a price equal to the cash surrender value, which was far below the amount of the premiums paid. The taxpayers in those cases tried to deduct as a loss the difference between the aggregate premiums paid and the cash surrender value. In those circumstances, it makes sense not to allow a loss for a portion of the asset that was used for personal use, because this would otherwise allow the cost of insurance to be effectively tax deductible. The Internal Revenue Code generally does not allow deductions for losses on capital assets used for personal consumption. Also, the Internal Revenue Code, in order to avoid potential abuses, recognizes several circumstances in which the basis for loss purposes is lower than the basis for gain purposes.

It is hard to think of any other capital asset whose basis is reduced by the current benefit it provides to its owner. For example, the basis of a house is not reduced by its rental value if the owner lives in it. The basis of corporate stock is not reduced by the value of the voting rights that the owner exercises each year. Every capital asset provides some current personal benefit to its owner, but life insurance contracts, which are not wasting assets, have been singled out for a reduction in basis. A court may disagree with the IRS' position.

PFIC Income

The Revenue Rulings did not address whether a life insurance policy produces PFIC income.⁴ It is not entirely clear whether the income from a life insurance policy on maturity or on disposition produces income that is treated as passive income under Section 954(c) for purposes of the PFIC regime. Based on the statutory language, the current Treasury regulations, and the absence of authorities to the contrary, we believe that income from a life insurance policy is not passive income, although a court could decide otherwise.

Recognition of Current Income for a Secondary Purchaser of Universal Life Policies

The fact that the rulings only address term-life insurance policies suggests that the IRS views universal life policies as raising additional tax issues. Some hint as to the IRS view is offered by a recent court decision in which the IRS successfully argued that the cash surrender value used to pay for an automatic premium loan was ordinary income to the holder of the policy when used to pay off the loan.⁵ If the cash surrender value were used, instead, to pay for current insurance protection, the IRS presumably would argue that it was currently includable ordinary income.

It is typical for Secondary Purchasers who purchase life insurance policies with cash surrender value to “strip out” that value and use it to pay premiums on the policy. Thus, the IRS may, potentially, view this as either current ordinary income or as a distribution that reduces the basis of the policy. Alternatively, the IRS may disallow the capitalization of premiums on policies with cash surrender value. Further clarification from the IRS on this point would be useful.

Trade or Business

The facts in Situation 3 of Revenue Ruling 2009-14 state that it is assumed that the Secondary Purchaser is a foreign corporation that is not engaged in a trade or business within the United States (including the trade or business of purchasing, or taking assignments of, life insurance contracts). This implies that the IRS, under some circumstances, might view mere purchasing and holding of life insurance policies to be a U.S. trade or business.

This language, however, parallels the language in Section 101(g)(2)(B)(i) that provides a definition of a viatical settlement provider. The definition provides that a viatical settlement provider is a “person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts” We believe that the language in Situation 3 was meant to exclude the entities that are life settlement brokers or providers and was not meant to imply that persons who merely invest in life insurance contracts are engaging in a U.S. trade or business.

Capitalization of Interest

The facts of the rulings do not discuss debt financing. Therefore the rulings do not address the issue of whether interest expenses are capitalized in the basis of the policies.⁶ From our experience, the IRS does not think that the interest can be capitalized.

Source of Income

The facts in Situation 3 of Revenue Ruling 2009-14 state that the insured is a U.S. person and the contract is issued by a U.S. corporation. These facts are used to support the conclusion that “by comparison and analogy” the death benefit is received from sources within the U.S. It is unclear what the source of income would be if the insured or the insurance company were not a U.S. person.

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1. All citations are to the Internal Revenue Code of 1986, as amended, or to the applicable Treasury regulations thereunder.
2. *Gallun v. Commissioner*, 327 F.2d 809 (7th Cir. 1964) (holding that taxpayer’s basis on sale of policies was not reduced by cost of insurance); *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1964) (concluding that taxpayer who sold an endowment contract 12 days before its maturity has to include in income the sale price reduced by the amounts he paid for the policy, including the premiums); Revenue Ruling 70-38 (ruling that no gain results if the amount received by the seller is less than the total premiums he paid while he held the contract); Office Decision 720, C.B. 3, 244 (1920) (no gain if a life insurance policy is sold for a sum less than the total premiums paid).
3. *Century Wood Preserving Co. v. Commissioner*, 69 F.2d 967 (3d Cir. 1934) (holding that no gain or loss is allowed when taxpayer sold a life insurance policy for its cash surrender value and attempted to claim losses); *Keystone Consolidated Publishing Co. v. Commissioner*, 26 B.T.A. 1210 (1932) (holding that no loss was sustained by the corporation upon the sale of the policies for their cash surrender value); *London Shoe Co. v. Commissioner*, 80 F.2d 230 (2d Cir. 1935) (holding that corporate taxpayer was not entitled to deduct as loss the difference between cash surrender value of policy on life of officer and net cost of policy).
4. A passive foreign investment company, defined in Section 1297(a), is a foreign corporation whose income is at least 75% PFIC income or that has at least 50% of its assets producing PFIC income. PFIC income generally includes passive income, such as interest, royalties, annuities and gains from certain sales of property, as defined in Section 954(c) and the Treasury regulations thereunder.
5. *Chambers v. Commissioner*, T.C. Summary Opinion 2009-63 (May 4, 2008) (holding that the cash surrender value used to pay for an automatic premium loan was ordinary income to the holder of the policy when used to pay off the loan).
6. Interest expense that is disallowed under Section 264(a)(4) is in effect capitalized for purposes of computing the taxable income of a holder of a life settlement policy upon the death of the insured. See Section 101(a).

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