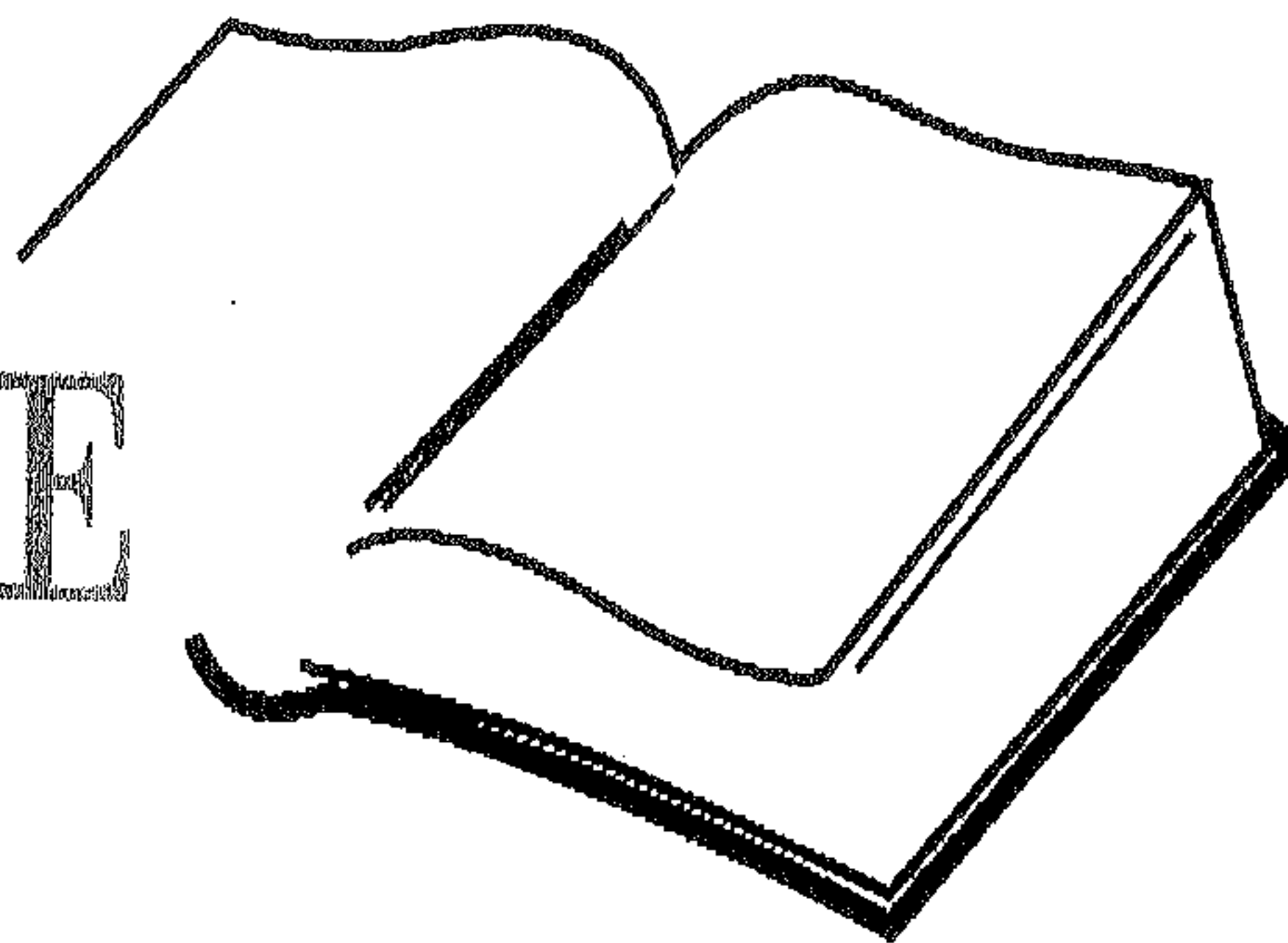


PROBATE PRACTICE Reporter™



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IRS Finally Explains Income Taxation of the Sale of a Life Insurance Policy

By Stephan R. Leimberg and Howard M. Zaritsky

One of the little-acknowledged important financial developments in the late 20th century has been the creation of a significant secondary market for life insurance policies. Hedge funds and other financial organizations have created a life settlement industry that includes significant investments in policies insuring the lives of individuals in whom the investors lack any natural or economic insurable interest. In some cases, this has afforded insureds who no longer need or desire a policy on their life a ready market in which to sell these policies instead of merely choosing between allowing the policies to lapse and surrendering them to the issuer for their cash surrender value. In other cases, it has resulted in purchases of substantial life insurance policies for the sole purpose of reselling them to unrelated investment concerns, in apparent violation of the spirit, and perhaps the letter, of the insurable interest rules.

Unfortunately, the income tax law has not kept pace with the changing financial realities of the life insurance and life settlement industry. There has been, until now, no clear IRS statement of the income tax consequences of a sale of a life insurance policy by the insured policy owner to an unrelated third party or the third party's receipt of death benefits or pro-

ceeds from the resale of the policy. The IRS has filled this gap nicely with *Revenue Ruling 2009-13*, 2009-21 I.R.B. ____ (May 26, 2009) and *Revenue Ruling 2009-14*, 2009-21 I.R.B. ____ (May 26, 2009) and, while these rulings still leave many questions unanswered, they provide a sound footing to analyze the most common life settlement transactions.

Revenue Ruling 2009-13: Insured's Surrender or Sale of a Life Insurance Policy

Revenue Ruling 2009-13 addresses the amount and character of income recognized upon the surrender or sale of the life insurance contracts in three situations.

Situation 1. Surrender of a Cash Value Life Insurance Policy

Situation 1 involved A, a cash method, calendar year individual taxpayer who bought and owned an insurance contract on A's own life. The policy had cash value, 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. The contract was a capital asset in A's hands.

On June 15 of Year 8, A surrendered the contract to the issuer for \$78,000, its cash surrender value. The IRS states that 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. A paid a total of \$64,000 of premiums on the policy, and neither received any distributions under the contract nor borrowed against its cash surrender value. As of the date of sale, A was neither terminally nor chronically ill within the meaning of the accelerated death benefit rules. I.R.C. § 101(g)(4).

The IRS ruled that A recognized \$14,000 of ordinary income on the surrender of the life insurance policy. The IRS applied section 72(e), which expressly governs amounts received on the complete surrender of a non-annuity life insurance contract. In particular, the IRS noted that section 72(e)(5)(A) requires that any non-annuity amount received on the complete surrender of a life insurance contract must be included in gross income to the extent that it exceeds the owner's investment in the contract. The investment in the contract is the aggregate amount of premiums or other consideration paid for the contract up to the date of surrender, less any amounts received under the contract up to that date to the extent that such amounts were excludable from gross income. I.R.C. § 72(e)(6).

A received \$78,000 on the complete surrender of the policy, so A included in gross income the excess of that amount over A's investment in the contract (\$64,000). A thus recognized \$14,000 of income on surrender of the contract.

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The IRS then determined that the \$14,000 gain on the surrender of the policy was ordinary income despite the fact that the policy was a capital asset. Section 72(e) does not specify whether income recognized upon the surrender of a life insurance contract is ordinary income or capital gain, but *Revenue Ruling 64-51*, 1964-1 C.B. 322, states that the surrender of a life insurance contract does not produce a capital gain because there is no sale or exchange.

The IRS also stated, without analysis or authority, that section 1234A does not change this result.

Situation 2. Sale of a Cash Value Policy

The facts of Situation 2 were identical to those of Situation 1, except that on June 15 of Year 8, A sold the life insurance contract for \$80,000 to B, a person unrelated to A and who would suffer no economic or personal loss upon A's death. The IRS first noted that section 72 does not apply to amounts received on the sale of a life insurance policy, so Situation 2 requires consideration of other general tax rules.

The IRS stated that A's gain on the sale was the excess of the amount realized by A on the sale over A's adjusted basis in the contract. I.R.C. §§ 1011, 1012. A's amount realized was \$80,000 — the sum of money received on the sale. A's adjusted basis in the insurance contract was the premiums paid by A, adjusted to reflect expenditures, receipts, losses, or other items properly chargeable to capital account. I.R.C. § 1016(a)(1). In this case, the IRS stated the basis should reflect only the investment component of the policy, and the premiums paid must, in determining basis, be reduced by the cost of the life insurance protection received by A during A's ownership of the policy. Citing *London Shoe Co. v. Commissioner*, 80 F.2d 230 (2d Cir. 1935), *Century Wood Preserving Co. v. Commissioner*, 69 F.2d 967

(3d Cir. 1934), and *Keystone Publishing Co. v. Commissioner*, 26 B.T.A. 1210 (1932). The IRS measured this by the \$10,000 by which the insurer reduced the cash surrender value to reflect cost-of-insurance charges. Accordingly, A's adjusted basis in the contract on the date of sale was \$54,000, and A's recognized gain would be \$26,000 (\$80,000 minus \$54,000).

The character of the gain was more difficult to determine in Situation 2 than in Situation 1, however, because the policy was a capital asset and there was an actual sale. Still, the IRS applied the "substitute for ordinary income doctrine," which allows the IRS to convert part of the gain into ordinary income. This doctrine, the IRS explained, provides that neither "property" nor "capital asset" includes "property representing income items or accretions to the value of a capital asset themselves properly attributable to income." *United States v. Midland-Ross Corp.*, 381 U.S. 54 (1965); *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260 (1958); *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988); *Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004); *Davis v. Commissioner*, 119 T.C. 1 (2002).

The IRS noted 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. *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960).

In Situation 2, the inside build-up in A's contract immediately before the sale was \$14,000 (\$78,000 cash surrender value less \$64,000 aggregate premiums paid). Therefore, A must recognize \$26,000 of

