IRS Addresses Consequences of Purchasing and Selling Life Insurance Contracts

Revenue Rulings Provide Guidance to Policyholders Who Surrender or Sell Life Insurance Contracts and to Investors Who Purchase Life Insurance Contracts From Policyholders

SUMMARY

On May 1, 2009, the Internal Revenue Service (“IRS”) issued Revenue Ruling 2009-13 and Revenue Ruling 2009-14 providing guidance on certain federal income tax consequences of surrenders, sales, and purchases of life insurance contracts. The most significant holdings of the rulings include the following:

- An original policyholder who sells a life insurance contract must reduce the tax basis in the contract by the cost of insurance, but an investor does not.
- Gain recognized by an original policyholder upon the surrender of a life insurance contract, and a portion of the gain recognized upon the sale of a life insurance contract, is ordinary income.
- Gain recognized by an original policyholder upon the sale of a life insurance contract is capital gain to the extent the sale price exceeds the cash surrender value of the contract.
- Gain recognized by an investor on the receipt of death benefits under a life insurance contract is ordinary income.
- An investor’s basis in a life insurance contract is increased by the amount of premiums paid under the contract.
- Gain recognized by a foreign investor on the receipt of death benefits under a life insurance contract is U.S. source income if both the insured and the insurer are U.S. residents and is therefore subject to a 30% withholding tax unless a tax treaty provides otherwise.
DISCUSSION

A. REVENUE RULING 2009-13

Rev. Rul. 2009-13 addresses three scenarios in which an individual purchases a life insurance policy from an insurance company on his or her own life and subsequently surrenders it or sells it to an unrelated investor. The holding with respect to the surrender of a whole life insurance contract to the insurer is effective immediately. The holdings with respect to the sale of a whole life insurance contract or a term life insurance contract will not be applied adversely to sales occurring before August 26, 2009.

1. Surrender of Whole Life Insurance Contract to Insurer

In the first situation, the policyholder surrenders the life insurance contract for its cash surrender value, an amount that economically would be reduced by amounts charged by the insurer for the cost of insurance up to the time of surrender. The ruling provides that the amount received upon surrender of the policy must be included in gross income to the extent it exceeds the individual's investment in the contract. For these purposes, the investment in the contract will generally equal the amount of premiums paid under the contract, less amounts previously received and not included in gross income. The IRS also held that the surrender of a life insurance contract produces ordinary income rather than capital gain.

2. Sale of Whole Life Insurance Contract to an Unrelated Investor

In the second situation, the policyholder sells the life insurance contract to an unrelated investor. The policyholder must recognize the excess of the amount realized on the sale over the adjusted tax basis in the contract. The ruling provides that the individual's tax basis generally will be equal to the amount of premiums paid under the contract, reduced by the portion of the insurance premiums attributable to the cost of insurance coverage. The ruling further provides that income on the sale of the contract is treated as ordinary income to the extent ordinary income would have been recognized had the contract been surrendered, i.e., in an amount equal to the excess of the cash surrender value over the investment in the contract.

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1 Section 72(e)(5). Unless otherwise noted, all Section references contained in this memorandum are to the Internal Revenue Code of 1986 (the “Code”), as amended.

2 Since the cash surrender value already reflects the cost of insurance, the investment in the contract is not reduced by that amount. Compare infra Part A.2.

3 Citing Rev. Rul. 64-51, 1964-1 C.B. 322. In this regard, the ruling explicitly states that Section 1234A does not change this result.

4 Section 1001(a).

5 Compare Rev. Rul. 2009-14, discussed below, which does not require an investor who purchases a life insurance contract from the original policyholder to reduce adjusted basis by insurance charges imposed after the purchase.
contract. Any additional income recognized on the sale (i.e., any gain arising from the excess of the sale price over the cash surrender value) will be treated as capital gain.

3. Sale of Term Life Insurance Contract to Unrelated Investor

In the third situation, the policyholder sells a term life insurance contract (with no cash surrender value) rather than a whole life insurance contract (with cash surrender value). Here too, the individual recognizes gain equal to the excess of the amount realized on the sale over the adjusted tax basis in the contract. The ruling provides, however, that the cost of insurance is presumed to equal the monthly premium under the contract. Thus, no amount of the premiums paid for past coverage will be included in the tax basis in the contract, and the full sale proceeds must be included in income. Additionally, because, a term life insurance contract has no cash surrender value, the ruling provides that all of the income recognized by the individual on the sale of the contract will constitute capital gain.

B. REVENUE RULING 2009-14

Rev. Rul. 2009-14 addresses three scenarios involving an investor who acquires from an unrelated U.S. resident individual a term life insurance contract issued by a U.S. insurer on his own life with no cash surrender value.

1. U.S. Investor’s Receipt of Death Benefits from Insurer

In the first situation, the insured dies and the investor, a U.S. resident, receives the insurance proceeds. The ruling provides that, under Section 101(a), the investor must include in gross income the excess of the amount of the death benefit received from the issuer over the sum of the consideration paid for the contract and the premiums paid to keep the contract in force. The ruling also holds that the receipt of death benefits under the terms of the policy produces ordinary income rather than capital gain.

2. U.S. Investor’s Sale of Life Insurance Contract to Unrelated Third Party

In the second situation, the investor, again a U.S. resident, sells the life insurance contract to an unrelated third party prior to the death of the insured. The investor must recognize income equal to the excess of the amount realized on the sale over the adjusted tax basis in the contract. In contrast to the

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6 In reaching this conclusion, the IRS relied on the “substitute for ordinary income” doctrine which generally provides that ordinary income may not be transformed into capital gain via a sale or exchange. See, e.g., Gallun v. Comm’r, 327 F.2d 809, 811 (7th Cir. 1964) (applying the substitute for ordinary income doctrine to characterize profit on a sale of a life insurance contract as ordinary income).

7 In this regard, the ruling assumes that the life insurance contract in the original policyholder’s hands is not property described in Section 1221(a)(1)-(8) and, thus, is not excluded as a capital asset.

8 Although the ruling does not mention Section 1234A, it presumably holds that Section 1234A does not apply to this situation.

9 Section 1001(a).
holding in Rev. Rul. 2009-13, however, here the investor is not required to reduce tax basis in the policy by the portion of the premiums attributable to insurance costs because the investor paid the premiums solely to prevent the lapse of a financial investment – and not to obtain the benefits of insurance protection. As such, the investor’s adjusted basis in the life insurance contract equals the sum of the consideration paid to acquire the contract and the premiums subsequently paid to keep the contract in force. Finally, because no income would be realized if the contract were surrendered to the issuer (i.e., the contract has no cash surrender value), the ruling holds that none of the income recognized by the investor on the sale of the contract is required to be treated as ordinary income.

3. Foreign Investor’s Receipt of Death Benefits from Insurer

In the last scenario addressed by the ruling, a foreign corporation that is not engaged in a trade or business within the U.S. purchases the life insurance contract from the insured and subsequently receives death benefits when the insured dies. As was the case with the U.S. investor,\(^\text{10}\) the ruling holds that the foreign investor must recognize the excess of the amount received from the issuer over the sum of the consideration paid for the contract and the premiums paid to keep the contract in force. Moreover, because such income is “fixed or determinable annual or periodical” income,\(^\text{11}\) the foreign investor is subject to 30% withholding tax under Section 881(a) if such income is from U.S. sources and not exempt under a tax treaty.\(^\text{12}\) In this regard, the ruling observes that neither the Code nor the regulations specify the source of income resulting from the payment of death benefits pursuant to a term life insurance contract but draws analogies to other Code provisions which provide that interest received from a domestic corporation is generally U.S. source income\(^\text{13}\) and that premiums received from the issuance of a life insurance contract are sourced based on the residence of the lives insured under the contract.\(^\text{14}\) Since both the life insurance company and the insured are U.S. residents, the ruling holds that the foreign investor’s income is from sources within the U.S.

CONCLUSION

Although Rev. Rul. 2009-13 and Rev. Rul. 2009-14 answer some long-standing questions regarding the calculation of adjusted basis and the character of gain recognized on the sale, surrender, or termination of a life insurance contract, the rulings fail to address other pertinent issues. In particular, the rulings do not state whether the rule that requires an individual to reduce basis by the cost of insurance applies to situations where an individual takes out a policy with the specific intention of selling it to an investor in the

\(^\text{10}\) See supra Part B.1.
\(^\text{11}\) See Section 881(a)(1).
\(^\text{12}\) The ruling does not discuss the application of tax treaties.
\(^\text{13}\) Section 861(a)(1).
\(^\text{14}\) Section 861(a)(7).
future. Rev. Rul. 2009-14 also specifically avoids the questions of whether and how a person can be engaged in a trade or business in the U.S. by purchasing life insurance contracts in the secondary market as well as whether income is U.S. sourced if either the insured or the insurer is not a U.S. resident.

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