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TAX
News Concerning Recent Tax Issues

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IRS LIFE INSURANCE GUIDANCE

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On May 1, 2009, the IRS issued two revenue rulings to clarify the income tax treatment relating to the surrender, sale and purchase of certain life insurance policies. They are in response to a congressional request for guidance for life settlement transactions in which such life insurance policies are sold to unrelated third parties. However, the principles in the revenue rulings may extend beyond such transactions. The IRS rulings address a number of issues involving the taxation of proceeds on surrender and death, the computation of gain on sale, tax basis and the availability of capital gain treatment. They help to settle certain issues, such as capital gain treatment on sale, but also present concepts, such as the reduction of basis for current insurance protection and the treatment of foreign purchasers, which differ from the prior reporting of such transactions by many taxpayers.

REV. RUL. 2009-13

The first ruling analyzes three factual scenarios involving the surrender or sale of life insurance policies by the owner/insured. The insured was not terminally ill and, therefore, the special tax rules relating to viatical settlements did not apply.

Situation 1 – The owner/insured of a whole life policy surrendered it to the insurance company for its cash surrender value. The ruling holds that the owner/insured recognizes ordinary income to the extent that the amounts received exceed the "investment in the contract," which is the aggregate amount of premiums paid for the contract.

For example, where the cash surrender value was $78,000 and the aggregate premiums were $64,000, the owner/insured had $14,000 of ordinary income. This result was not affected by the fact that the insurer had charged the policy $10,000 over the years as the cost of current life insurance protection.

Situation 2 – The owner/insured sells the whole life policy in Situation 1 to an unrelated purchaser who has no insurable interest in the policy for $80,000, which exceeds the cash surrender value. The ruling holds that the owner/insured recognizes a gain on the sale of the contract equal to the difference between the amount received ($80,000) and his adjusted basis for tax purposes. Such adjusted basis is equal to the aggregate premiums which he paid on the policy ($64,000) less an amount allocated to the cost of the annual insurance protection which the policy provided ($10,000). Of the $26,000 gain recognized, an amount equal to $14,000, the difference between the cash surrender value ($78,000) and the aggregate premiums paid ($64,000) (i.e., the "inside build-up" under the contract) is taxed as ordinary income. The balance of the gain ($12,000) is taxed as long-term capital gain.

The ruling merely represents that $10,000 was the value of current life insurance protection. It does not state how such a number would be determined for particular types of policies.

Situation 3 – The owner/insured sells a level premium term life insurance policy to an unrelated third party who has no insurable interest. The annual premiums cover the insurance protection and there is no cash surrender value in the policy. The ruling holds that the amount received from the sale of the policy, reduced only by the unamortized premium from the year of sale, is taxed as long-term capital gain. The seller has no adjusted basis in the policy except for the unexpired portion of the last year's premium.

Rev. Rul. 2009-13 states that the holdings, with respect to Situations 2 and 3, will not be applied adversely to sales of policies occurring before August 26, 2009.

REV. RUL. 2009-14

The second ruling relates to the tax treatment to an unrelated purchaser of a term life insurance policy where the purchaser has no insurable interest and purchases the policy with a view toward profit. It also covers three scenarios.

Situation 1 – The owner/insured sells a level premium term life insurance contract to the purchaser for $20,000. The contract has no cash surrender value. The purchaser pays $9,000 of additional premium payments to keep the policy in force. The insured dies and $100,000 is paid to the purchaser by reason of the insured's death. The ruling holds that under the "transfer for value rule," the purchaser is taxed on an amount equal to the death proceeds less the original purchase price for the policy and the amount of premiums subsequently paid by the purchaser. All of the $71,000 ($100,000 - $20,000 - $9,000) is taxed as ordinary income.

Situation 2 – The facts are the same as in Situation 1, except that before the death of the insured, the original purchaser sells the contract for $30,000 to a new purchaser, who is also unrelated to either party. In that case, the first purchaser recognizes a gain of $1,000 on the difference between the amount received from the second purchaser ($30,000) and the sum of amount paid to the insured ($20,000) and the premiums ($9,000) paid by the first purchaser during the time he held the contract. The entire gain qualifies for long-term capital gain treatment. The premiums paid by the first purchaser are includable in his adjusted basis, even though they were applied to current life insurance protection.

Situation 3 – The facts are the same as in Situation 1, except that the purchaser is a foreign corporation that is not engaged in a trade or business within the United States. The insured was a U. S. citizen and the insurance company was a domestic corporation. The ruling holds that the income recognized upon the receipt of death benefits is treated as gain from sources within the United States for purposes of taxing foreign corporations.

These IRS rulings clarify a number of issues but are not be applicable to all circumstances. Please contact Arthur Zatz if you have any questions.

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