IRS Explains Income Taxation of a Sale or Surrender of a Life Insurance Policy

By Kenneth W. Kingma

The IRS recently issued revenue rulings outlining its positions on the income taxation of a sale or surrender of a life insurance policy. Each ruling discusses three situations. In each situation the IRS analyzed whether any proceeds received from the sale or surrender of a policy constituted taxable income, and if so, whether the taxable portion was ordinary income or long-term capital gain income. Under current tax law, individual taxpayers favor long-term capital gain income over ordinary income because the highest tax rate for long-term capital gain income is generally 15 percent, while the highest tax rate for ordinary income is 35 percent.

Revenue Ruling 2009-13 – Tax Guidance for Owner/Insured

Situation 1 – Owner/Insured *surrenders* a whole life policy.

- Fact: Policy is surrendered for cash surrender value (CSV).
- Ruling: CSV in excess of aggregate premiums paid is *ordinary income* to owner.
  - > Policy surrender does not produce capital gain.

Situation 2 – Owner/Insured *sells* whole life policy to an unrelated investor.

- Fact: Policy was held for more than one year prior to sale.
- Ruling: Portion of sales proceeds up to the "inside build-up" is *ordinary income* to seller under the "substitute for ordinary income" doctrine.
  - > The "inside build-up" equals CSV *less* seller's adjusted basis.
  - > Adjusted basis equals aggregate premiums paid *less* cost of insurance prior to sale.
- Ruling: Portion of sales proceeds in excess of "inside build-up" is *long-term capital gain income* to seller.

Situation 3 – Owner/insured *sells* level term policy to an unrelated investor.

- Fact: Policy held for more than one year prior to sale.
- Fact: There was no "inside build-up" because there was no CSV.
- Ruling: Sales proceeds in excess of seller's nominal basis is *long-term capital gain income* to seller.
  - > Seller's nominal basis is the unearned premium at time of sale.
  - > IRS treated cost of insurance as being equal to total premiums paid and earned prior to sale.

Revenue Ruling 2009-14 – Tax Guidance for Unrelated Investor

Situation 1 – Same as *Situation 3* in Rev. Rul. 2009-13 but policy subsequently matures.

- Fact: Investor pays policy premiums after purchase.
- Ruling: Death benefits in excess of investor's adjusted basis are *ordinary income* to investor.
  - > Adjusted basis is equal to purchase price and aggregate premiums paid by investor.
  - > Exceptions to transfer-for-value rule do not apply here to exempt more proceeds from income taxation.
  - > Death proceeds treated as ordinary income because no "sale or exchange" of a capital asset occurred.

Situation 2 – Same as *Situation 3* in Rev. Rul. 2009-13 but investor sells term policy to another investor prior to maturity.

- Fact: Policy held by selling investor for more than one year.
- Ruling: Sales proceeds in excess of seller's adjusted basis are *long-term capital gain income* to seller.
  - > Adjusted basis equals the purchase price and aggregate premiums paid by seller.
  - > No basis reduction was required for cost of insurance because seller purchased the policy as an investment and not for insurance protection.

Situation 3 – Same as *Situation 3* in Rev. Rul. 2009-13 but policy subsequently matures and the investor is a foreign corporation.

- Fact: Investor is not engaged in a U.S. trade or business.
- Ruling: Death benefits are U.S. source income to investor.
- Ruling: Death benefits in excess of investor's adjusted basis are *ordinary income* to investor.
  - > Adjusted basis is equal to purchase price and aggregate premiums paid by investor.

The revenue rulings represent the first definitive statement by the IRS on its views regarding the income taxation of a sale or surrender of a life insurance policy. They also take positions that are beneficial and detrimental to tax payers. Both rulings confirm the availability of capital gain treatment for part of the gain recognized on the sale of a policy. Revenue Ruling 2009-13 states that an owner/insured's basis in a policy must be reduced by the cost of insurance if the policy is sold to an unrelated investor.

Under that position, the aggregate amount of premiums paid by the owner/insured must be reduced by the cost of insurance prior to sale. Time will tell how that position will impact the life settlement industry. Reducing the owner/insured's basis by the cost of insurance could significantly increase the amount of income tax payable when an owner/insured sells a policy, which would make such sales less appealing.

Although the revenue rulings take controversial positions and leave questions unanswered (e.g., no guidance as to how the cost of insurance is to be calculated), they offer tax payers a degree of confidence not previously available. ■

About the Author

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