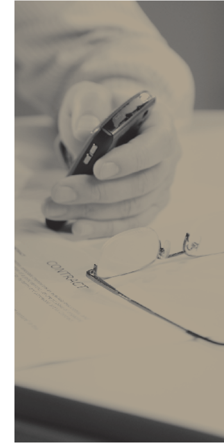
SOCIETY OF ACTUARIES

Article from:

Taxing Times

September 2009 – Volume 5, Issue 3

RECENT GUIDANCE INVOLVING THE TAXATION OF LIFE SETTLEMENT TRANSACTIONS



By Frederic J. Gelfond and Yvonne S. Fujimoto

IF YOU GIVE A MOUSE A COOKIE,
HE'S GOING TO ASK FOR A GLASS OF MILK.
WHEN YOU GIVE HIM THE MILK,
HE'LL PROBABLY ASK FOR . . .[1]

As the life settlement industry continues to take deeper root, arguably the first seeds of tax guidance have only recently been planted for sellers and investors in existing life insurance contracts. In May 2009, the Internal Revenue Service (Service or IRS) released two revenue rulings—Revenue Ruling 2009-13 and Revenue Ruling 2009-14 (the Rulings)—that provide their answers to some of the questions raised by taxpayers involved in the secondary market for life insurance contracts. Many of the questions revolving around the taxation of life settlement transactions were identified in a February 2009 article in *TAXING TIMES* (the February 2009 Article).[2] That article centered on the complexities involved in, and anomalies resulting from, the application of current life insurance tax guidance to life settlement transactions, as it appears that the current tax laws and existing guidance did not contemplate the development of a secondary market for life insurance contracts.

ANSWERS THAT BEGET EVEN MORE QUESTIONS

The questions identified in the February 2009 article touch upon what one might think are basic concepts that would have been resolved decades ago with respect to the purchase, sale and a purchaser's holding of an existing life insurance contract. The questions involved issues around how to determine basis in a life insurance contract, how to measure gains and losses associated with a sale of a contract, assuming one can recognize a loss on a life insurance contract, and whether income or, potentially, loss that is recognized should be characterized as ordinary or capital.

The Rulings each describe three scenarios that the Service uses to provide answers to many of these questions. But, because the rulings are specific to their facts and provide only limited analyses of some issues, they leave many questions unanswered, and cause many others to be asked.

The February 2009 article also mentioned questions regarding the application of various anti-abuse provisions in the Internal Revenue Code,[3] such as those involving the deductibility of interest on debt incurred with respect to an insurance policy. Neither of the Rulings directly address those types of issues, though an argument can be made that Revenue Ruling 2009-14 might provide some limited assistance in that area.

In light of all the uncertainty regarding the IRS view of this evolving industry, it is helpful that they have at least made their positions on some key questions known.

REVENUE RULING 2009-13: SURRENDER OR SALE BY ORIGINAL, INDIVIDUAL OWNER/INSURED

Revenue Ruling 2009-13, applies to an individual taxpayer who is the original policyholder and insured under a life insurance contract. In each of the three scenarios presented in the ruling, the individual either surrenders or sells the policy. In Situation 1, the holder surrenders the contract to the insurance company for its cash surrender value. In Situation 2, the holder sells the policy to an unrelated party for an amount in excess of its cash value. Situation 3 also involves a sale, but the contract is a term policy that does not have a cash value associated with it.

An Initial Matter

As an initial matter, because the ruling specifically states that it applies to an individual, it is unclear as to whether the principles it sets forth are intended to be similarly applicable in a situation involving a nonindividual taxpayer. In contrast, the facts set forth in Revenue Ruling 2009-14, establish that the ruling applies to a "U.S. person," which can be an individual or nonindividual taxpayer.

Even though the ruling cites cases involving nonindividual taxpayers in its analyses, the failure to specifically address nonindividual taxpayers in Revenue Ruling 2009-13 is an important omission. Many original owners of life insurance contracts that are sold on the secondary market are businesses that no longer need their policies; for example a business with a key-man policy purchased on an employee who subsequently

CONTINUED ON **PAGE 28**

leaves the firm, or a corporation that disposes of a corporate-owned life insurance (COLI) program.

This leaves a big question mark with respect to one of the key distinctions between the IRS position on the treatment of an original policyholder in Revenue Ruling 2009-13 and that of an investor in an existing policy, which is the subject of Revenue Ruling 2009-14. As discussed below, that key distinction is the IRS view that an original policyholder must reduce its basis upon its sale of a contract by cost of insurance charges, whereas the investor of an existing policy does not need to. The rationale provided in the ruling is that a secondary purchaser views a policy as a purely financial investment; unlike an original purchaser who the ruling asserts purchases a policy for protection against economic loss in the event of the insured's death.

While not using the terms insurable interest, it appears that the Rulings are suggesting that the existence of an insurable interest is determinative of a policyholder's motivation for acquiring a policy; and is thus, the distinguishing factor for tax purposes, between an original and secondary purchaser.

Similar to secondary investors, however, corporate taxpayers who are original purchasers also frequently purchase contracts as financial investments; for example, those who enter into COLI programs that serve as aggregate funding mechanisms for various employee benefit programs. Moreover, one could also envision many situations in which an individual, original purchaser is predominantly interested in the investment aspects of a policy, rather than protection against economic loss.

Regardless of whether one agrees whether it is appropriate for any taxpayer to reduce basis by cost of insurance charges, it is curious that the rulings base a technical distinction in the tax treatment solely on a policyholder's rationale for buying a policy. For example, one would think that if a distinction in the treatment is necessary, the rulings might have supplemented the reasoning by basing such distinction on the fact that Congress treats original purchasers and secondary owners differently by virtue of the transfer for value rules.[4] That is, unlike original owners, secondary purchasers generally do not receive tax free treatment upon the receipt of death benefits. While that has nothing directly to do with the basis question, it does perhaps provide a more solid foundation for potentially distinguishing between the treatment of original and secondary owners when looking at the tax treatment of life settlement transactions more globally.

Basic Tax Treatment of Original Holders of Life Insurance Contracts

Under the general tax rules for holding a life insurance contract, death benefits are excluded from taxable income.[5] Premiums paid for a life insurance contract by a direct or indirect beneficiary under the contract are not deductible.[6]

If a policyholder surrenders its contract to the insurance company, and receives an amount reflective of an associated cash value account, the policyholder will be subject to tax to the extent that the amount received upon surrender exceeds the policyholder's "investment in the contract." The investment in the contract is the total amount of premiums or other amounts paid for the contract less any amounts that might have been previously distributed under the contract that were excluded from income.

In effect, Congress has determined that the "basis" to be used in measuring the amount of gain attributable to cash value build-up upon the surrender of a contract includes the total amount of premiums and other amounts paid for the contract.

Typically, an insurance company will impose mortality, expense, and other charges on a policyholder in exchange for providing insurance coverage. A portion of each premium paid will go towards paying these mortality and other charges. This mortality charge, or the amount of explicitly identified mortality charges will differ, depending on how a given insurance company markets its policies. In fact, some companies offer "no-load" policies that purportedly involve no mortality charges at all, or front-end loaded policies in which the insurance company takes out a greater percentage of such charges earlier in the life of a policy, or back-end loaded policies in which the charges are taken out later.

A mortality charge is different from an insurance company's cost of insurance. A cost of insurance reflects what the insurance company actually incurs in providing death benefits to beneficiaries of matured policies. To simplify this concept, one might analogize an insurance company's cost of insurance to an automobile manufacturer's cost of goods sold in building and selling a car. When a purchaser of an automobile determines its basis in the vehicle, it does not consider the manufacturer's cost of goods sold.

Congress is fully aware of these mortality charge and cost of insurance concepts. In fact, they are considered in the definition of life insurance contract under section 7702, as well as the limits set forth in section 7702A dealing with modified endowment contracts.

Even though a policyholder receives protection during the life of a contract, and hence, arguably incurs or "expends" these costs, Congress nevertheless determined that the basis of a contract for purposes of determining gain upon a surrender is not reduced for costs of insurance incurred by the issuer or for mortality charges set forth in a life insurance contract.

Nevertheless, as discussed below, one of the fundamental questions addressed in the Rulings is whether in determining basis in the case of a sale of a life insurance contract the seller must reduce basis by some form of cost of insurance charges. Revenue Ruling 2009-13 suggests that it is necessary to do so in the case of an original, individual seller of a contract. In doing so, it cites three judicial authorities issued in the 1930s. There are, however, judicial and other authorities that were released subsequent to those 1930s cases that indicate that one need not determine gain upon a sale by reducing for cost of insurance charges. Some of these cases are cited in Revenue Ruling 2009-13 with respect to issues other than the basis question, but the ruling does not distinguish them for purposes of its analysis regarding a policyholder's basis.

SITUATION 1

In the first of the three scenarios presented in the ruling, the individual surrenders the life insurance contract for its cash surrender value of $78,000 after having paid $64,000 in premiums throughout the life of the contract. The $78,000 cash surrender value reflected the subtraction of $10,000 in cost-of-insurance charges collected by the insurance company during the period of coverage prior to the surrender. The ruling concludes that, upon the surrender, the individual must recognize income of $14,000, the amount by which the cash surrender value of $78,000 exceeds the "investment in the contract" of $64,000.[7] This is a simple application of the general rule that gain upon the surrender of a life insurance contract is equal to the excess of the proceeds received upon surrender—generally, the cash surrender value—over the policyholder's investment in the contract.

Character on Surrender

The ruling next concludes that the income received upon a surrender of a contract should be treated as ordinary income. In reaching this conclusion, the ruling recognizes that the Code provisions governing the measurement of income upon surrender do not provide guidance on how such income should be characterized. Accordingly, the ruling first looks to the definition of capital gain in the Code, which defines that term as gain from the "sale or exchange of a capital asset."[8] Continuing its analysis, the ruling confirmed that a life insurance contract is a capital asset,[9] but also stated that the surrender of a contract does not produce a capital gain.

In reaching this conclusion, it cites Revenue Ruling 64-51 which noted that "the proceeds received by an insured upon the surrender of, or at the maturity of, a life insurance policy constitutes ordinary income to the extent such proceeds exceed the cost of the policy." In doing so, Revenue Ruling 2009-13 appears to rely solely on that summary statement contained in Revenue Ruling 64-51. In other words, Revenue Ruling 2009-13 stops short of actually making the further statement in the analysis under Situation 2 that a surrender does not result in a capital gain for the additional reason that a surrender is not a "sale or exchange."

Continuing its analysis, the ruling confirmed that a life insurance contract is a capital asset, but also stated that the surrender of a contract does not produce a capital gain.

The likely response to this is that such a finding is inherent in the ruling. Arguably supporting that, is the analysis under Situation 2, which involves a sale of a contract, rather than a surrender. Contained in that discussion is a statement that, "Section 72 has no bearing on the determination of the basis of a life insurance contract that is sold, because section 72 applies only to amounts received under the contract."

The above conclusions regarding the measurement of income upon a surrender, reflect the application of section 72; and hence, consider the amounts received upon a surrender to be amounts received under a contract. It would thus appear to logically follow that the IRS view is that a surrender is not a sale or exchange. As noted below, under the discussion of Situation 2, the characterization of whether amounts are received pursuant to a sale or exchange, or under a contract, is important for several reasons. Among such reasons are

CONTINUED ON PAGE 30

the sourcing and other international tax provisions that are mentioned, but not fully analyzed in Revenue Ruling 2009-14.

The conclusion the ruling reaches as to the amount of income to be recognized upon a surrender, as well as the fact that such income should be treated as ordinary is neither surprising nor controversial. Nevertheless, it is interesting that the ruling takes the time to present the legal definitions of a capital gain and capital asset, but does not specifically state why a surrender transaction falls outside of those rules, choosing instead to cite to a summary conclusion in a prior ruling.

Although it is useful for the ruling to mention those rules, this ruling also presented an opportunity to provide further useful guidance. For example, the ruling further states that section 1234A "does not change this result." That section treats gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to a capital asset as gain or loss from the sale of a capital asset, except in the case of the retirement of a debt instrument. The ruling does not state, however, why that section does not change the result.

Again, it would be helpful to know the IRS' views on this, as questions frequently arise as to what it means to surrender a life insurance contract. For example, is it a cancellation or termination of a right? Or perhaps, is it an exercise of a right? Is it a statement that neither a "surrender," a "redemption," nor a "maturity," the operative terms under section 72, constitute a cancellation, lapse, expiration, or other termination of a right or obligation referred to in section 1234A?

Further, it is not uncommon for questions to arise as to whether a life insurance contract, or, more frequently, an annuity contract, is a form of debt instrument. Is that why section 1234A does not change the result?

Alternatively, is such conclusion reached out of a concern that section 1234A would provide a taxpayer a basis upon which to claim a loss under a life insurance policy? Neither of the Rulings presents a scenario in which a policy is surrendered or sold for a loss. That is a topic that has been the subject of considerable public discussion, and is particularly relevant given today's current economic environment in which many policyholders are holding, for example, variable policies that have significantly reduced cash value accounts. Guidance in that area would have been helpful as well.

SITUATION 2

In the second scenario described in the ruling, the facts are the same as in Situation 1, except that the individual owner/insured sells the existing life insurance policy to an unrelated person for $80,000, instead of surrendering it to the insurance company. As noted above, the ruling also states that the cash surrender value of $78,000 reflects a $10,000 subtraction for "cost-of-insurance" charges collected by the insurance company for periods ending prior to the sale. The ruling concludes that the transaction is governed by section 1001(a), which provides that the gain realized from the sale or other disposition of property is the excess of the amount realized over the adjusted basis. The ruling then concluded that the policyholder's basis in the life insurance contract is $54,000, which is equal to the $64,000 of premiums paid reduced by the $10,000 of cost-of-insurance charges, and the resulting gain on sale is $26,000, or $80,000 less $54,000.

As pointed out in the ruling, "adjusted basis for determining gain or loss is generally the cost of the property." Under a section 72 "investment in the contract" theory, Congress mandated that the "cost" to be subtracted from the amount received in determining gain upon the surrender of a contract, is generally the amount of premiums paid under the contract, less any amounts that may have been returned to the policyholder on a tax-free basis.

Revenue Ruling 2009-13 distinguishes between an amount received upon a surrender of a contract, and that is hence, governed by section 72, and an amount that is received upon a sale of a contract. As noted:

> Section 72 has no bearing on the determination of the basis of a life insurance contract that is sold, because section 72 applies only to amounts received under the contract.

Instead, the IRS looks to various cases from the 1930s,[10] involving situations in which taxpayers were seeking to claim a loss upon a sale or surrender of a life insurance contract. These cases indicated a view that basis in a life insurance contract should be reduced for amounts that were reflective of amounts paid for insurance coverage prior to the time the contracts were sold or surrendered. The rulings, however, fail to also address in this context, subsequent cases that actually applied an investment in the contract theory for determining basis in a life insurance contract, and numerous legislative and judicial authorities that have specifically analogized the terms "investment in the contract" and "basis."

See, for example, *Gallun v. Commissioner*,[11] which is cited in Revenue Ruling 2009-13 solely for the proposition that a gain on sale is partially ordinary income. The ruling does not seek to distinguish the fact that the amount of gain recognized by the selling policyholder in that case was determined based on the premiums paid for the subject contracts, with no reduction for cost of insurance charges. Cost of insurance charges were clearly considered by the court in that case, as it mentioned the impact of various expenses and charges in reducing the contracts' total cash surrender value.

Given the divergent authorities on this issue, it is likely to be an area of continuing conversation among practitioners. On one side of the debate will be those who point to the fact that a policyholder receives insurance coverage for the period that it holds the policy, and hence, must have incurred charges during that time period. On the other side will be those who focus on the fact that premiums paid are for coverage during the whole of the life of the insured or the entire term of coverage; and that the magnitude of the benefits that are made available during the entire period are a function of all the premiums paid during the life of the contract. Even in the case of a term policy for a number of years, there is an interrelationship between the premiums paid in all years to the benefits that are made available throughout the life of the contract.

Others might point to the fact that, from the policyholder's standpoint, there is no substantive difference between a sale and a surrender. That is, in both cases, the policyholder is giving up all rights under a contract. In the case of a surrender, Congress deemed it appropriate to give the policyholder "basis" credit for the entire amount paid for the contract.

Similarly, in a situation involving the transfer for value rules described below, the purchaser is given credit for all amounts paid for a contract, unreduced by cost of insurance charges.

Even if there was full agreement that it is appropriate to reduce basis by cost of insurance charges, there are likely to be several practical issues as to how to determine what those cost of insurance charges should be. Is it the mortality charge stated in the contract or otherwise collected by the insurance company? Is it the insurance company's cost of insurance? If it is the former, how can one determine such charges if they are not explicitly stated in the contract? Further, how might one figure into this

calculation, the extent to which a return of cost of insurance charges are inherent in a policyholder dividend that is paid in a subsequent year, or that is effected through some other form of policy crediting? That is, should there not be an increase in basis to the extent that an insurance company credits favorable mortality experience back to its policy holders. Will the result of all this be a lack of uniformity in terms of how taxpayers compute these charges?

Character on Sale

Even though the rulings recognize that life insurance contracts are capital assets, and the transaction in Situation 2 is a sale or exchange, the ruling nevertheless treats at least a portion of the gain on the sale as ordinary income. More precisely, the ruling concludes that the portion of the $26,000 gain that reflected the amount of income the policyholder would have been required to recognize upon a surrender of the contract ($14,000, equal to the $78,000 cash surrender value less the $64,000 investment in the contract) should be treated as ordinary income, and the remainder of the gain ($12,000, equal to $26,000 total gain less $14,000 of ordinary income) should be treated as capital.

In doing so, the ruling followed a "substitute for ordinary income" theory discussed in a long line of cases involving insurance and other capital assets that were treated as capital, but that also were deemed to generate ordinary income that increased the value of the asset, but was not previously recognized by the seller. Essentially, those courts examined, "whether the gain realized thereon represented an appreciation of the capital asset itself, or rather represented income produced by such asset."[12] Those courts sought to prevent gains that they deemed to be reflective of ordinary income from being converted to capital gain by a sale or

CONTINUED ON **PAGE 32**

exchange. With respect to insurance contracts, those courts analyzed the character of the gain attributable to the inside buildup in terms of how that gain would have been treated had the contract been surrendered.

There is a good deal of authority to support this approach.[13] It is interesting, however, that in the discussion of cost of insurance charges noted above, the rationale that the Rulings provide for treating an original purchaser and an investor in the secondary market differently from a basis perspective, is because the original purchaser acquires a policy for protection against loss in the event of death, not for the investment aspects of a policy. If that is the case, then it would seem that ruling would have recognized that the accretion to value of the policy in the ruling is attributable to the increasing value of the death benefit, not because of the inside buildup in the policy. In fact, in the secondary market, the value of the policy is based on a determination as to the present value of the death benefit. A large cash value is commonly deemed to be a hindrance towards the efficient administration of the contract once acquired, and is typically reduced to the extent possible without terminating the policy. As such, one might view the cited cases as being not fully consistent with the common fact pattern in a life settlement transaction. That is, the value of a policy is not based on its cash surrender value, it is based on the expected date of death of the insured.

Another interesting aspect to this is that by virtue of the manner in which this calculation is performed, the ruling would at least mathematically convert a cost of insurance expenditure into a capital gain upon a sale of the associated contract.

SITUATION 3

Situation 3 involves the sale, for $20,000, of a term life insurance contract that has no cash value. Because the policy has no cash value, the full amount of the premium, or $500 per month, is considered to be cost of insurance. The seller paid premiums on the policy at the beginning of each month for 90 months, for a total of $45,000 in premium payments over that term. The policyholder sold the policy in the middle of the 90th month. In accordance with the approach it set forth in Situation 2, the ruling concludes that the policyholder's basis in the contract is $250 ($45,000 of total premiums less $44,750 cost of insurance deemed to have been incurred after 89.5 months), and that the policyholder would be required to recognize a gain on sale of $19,750. Because the contract was held for more than one year, the gain is deemed to be a long-term capital gain.

In selling the contract at this time, the policyholder is giving up its rights to continuing insurance coverage for the remaining seven and a half years of insurance coverage. The policyholder is ascribed no basis in those rights that it is giving up.

The ruling does not state whether the death benefit remains the same through the life of contract. As such, it is not clear whether the premiums paid in the expired years include amounts that are at least in part, reflective of costs of coverage for the later years. In fact, the ruling states, "absent other proof," the cost of insurance charge each month is equal to the entire monthly premium of $500. It is uncertain whether it was appropriate to reduce the policyholder's basis by the full $500 premium paid each month, assuming the ruling is correct in its conclusion that it is proper to reduce for costs of insurance in the first instance. Everything else aside, the suggestion that the conclusion is being made "absent further proof," is perhaps foreshadowing the fact that policyholders are likely to have a significant burden to overcome in substantiating basis in this area.

EFFECTIVE DATE

Perhaps recognizing that the positions set forth in this ruling reflect a change in how many taxpayers have been calculating and characterizing income relative to their life settlement transactions, the ruling indicates that the holdings relative to Situations 2 and 3 will not be applied adversely to sales occurring before August 26, 2009.

REVENUE RULING 2009-14: SECONDARY MARKET PURCHASER'S TAX TREATMENT

Revenue Ruling 2009-14, offers tax guidance to an investor in a life insurance contract in the secondary market; *i.e.*, a purchaser[14] of an existing life insurance contract. Similar to Revenue Ruling 2009-13, Revenue Ruling 2009-14 presents three scenarios that illustrate the IRS positions on the amount and character of income the purchaser should recognize with respect to certain life settlement transactions. In two of the three scenarios, the purchaser is a U.S. person—*i.e.*, an individual or an entity—who buys a term life insurance contract from a U.S. individual and either receives the death benefit on the contract or sells the contract to an unrelated purchaser while the insured is still alive. The third scenario involves a foreign purchaser of an existing contract who holds the policy until receipt of the death benefit.

The ruling uses a general fact pattern that steers clear of many of the questions that have been raised in the life settlement

area. In particular, none of the scenarios involve the transfer of a policy that has a cash value, or that is a whole life policy. None of the scenarios involve the use of indebtedness, which is a common feature of many life settlement structures. The rulings provide citations to various Code sections implicated by each of the scenarios, but it provides virtually no analyses with respect to the associated conclusions.

As discussed above, among the general rules governing the purchase, holding and maturity of a life insurance contract are that premiums paid by a direct or indirect beneficiary under the contract are not deductible, and amounts received upon the death of the insured are excludable from income. The latter rule does not apply, however, in the case of a contract that has been acquired in a transfer for value; *e.g.*, as occurs in a life settlement transaction. In a circumstance involving a transfer for value, only the portion of the death benefit that reflects the "cost" of the contract to the policyholder would be excluded from taxable income.

The amount that is excluded is the value of the consideration paid for the contract plus premiums and other amounts subsequently paid by the transferee. The "other amounts" include interest payments that are disallowed as a deduction pursuant to section 264(a)(4).

The interest deduction limitation rules set forth in section 264 are designed to prevent perceived abuses relative to the original purchase and ownership of life insurance policies by individuals and businesses that are generally able to defer or otherwise exclude income from their contracts. In general, these rules reflect an attempt by Congress to limit taxpayers' ability to deduct amounts incurred in connection with the generation of tax-deferred or tax-free income. Yet, it is questionable how, if not whether, many of these rules should be applied in the context of a business operating in a secondary market in which the income from death benefits is generally subject to tax; *i.e.*, they do not involve the same opportunities for arbitrage as may exist with respect to policies held by their original owners.

The ruling refers to the application of section 264 as it relates to its limitation on the deductibility of premiums by a direct or indirect beneficiary. The fact patterns in the ruling, however, do not involve the use of debt or a policy with a cash value. As such, it does not address some of the more significant questions involved in a typical life settlement structure. Because of the magnitude of this issue, uncertainty around the application of the interest deductibility limitations in particular is one of the largest drivers of life settlement structures being set up in offshore jurisdictions.

On the other hand, the transfer for value rule, referred to above, permits the policyholder to include in the cost of the policy that may be excluded from income, interest expense that was otherwise disallowed as a current deduction. In effect, the policyholder may capitalize, rather than currently deduct, this otherwise disallowed interest expense for the purpose of measuring the taxable portion of death proceeds. It is uncertain, however, whether such disallowed interest would be permitted to be capitalized in the case of a sale of a contract by the secondary market investor. The ruling answers this question in the context of premium deductions disallowed under section 264, permitting such amounts to be capitalized, but it does not address the question as it relates to disallowed interest deduction amounts.

SITUATION 1

In the first scenario, the purchaser pays $20,000 for a level premium 15-year term life insurance contract without cash surrender value and names itself as beneficiary. The contract is underwritten by a domestic insurance company on the life of a U.S. citizen residing in the United States. The purchaser buys the policy from the insured solely for the purpose of making a profit, has no insurable interest in the life of the insured, and has no relationship to the insured.

The ruling refers to the application of section 264 as it relates to its limitation on the deductibility of premiums by a direct or indirect beneficiary.

The insured dies and the purchaser/beneficiary receives a $100,000 death benefit. Prior to the insured's death, the purchaser paid the monthly premiums totaling $9,000 to keep the contract in force. The ruling concluded that as a transfer for valuable consideration, section 101(a)(2) provides that the death benefit is included in taxable income in an amount equal to the amount received upon the death of the insured less the sum of the consideration paid for the contract and the premiums and other amounts subsequently paid. The purchaser will include $71,000 of the death benefit in gross income, which is equal to the $100,000 death benefit received less $29,000 ($20,000 purchase price form original owner plus $9,000 in monthly premiums).

This conclusion reflects a straightforward application of the transfer for value rules. Most secondary market transactions

CONTINUED ON **PAGE 34**

involve a number of other fees or amounts paid in connection with the acquisition of a contract beyond the purchase price paid to the seller and the additional premiums paid to the insurance company. It will be interesting to observe what other items might be included in the "other amounts" paid that may be excluded from income.

Character of Death Benefits

Similar to Revenue Ruling 2009-13, this ruling concludes that a life insurance contract is a capital asset. Despite this characterization however, the IRS determines that "neither the surrender of a life insurance or annuity contract nor the receipt of a death benefit from the issuer under the terms of the contract produces a capital gain" and declares that the $71,000 is ordinary income. Although not unexpected, the ruling provides no explanation for this conclusion; something that would have been helpful given the frequency with which this question is raised by taxpayers.

SITUATION 2

The second scenario in Revenue Ruling 2009-14 is similar to the first scenario except that the secondary owner resold the policy prior to the death of the original insured, to a purchaser unrelated to either the original or the secondary owner. The sales price received for the contract was $30,000.

Similar to the sale transaction in Revenue Ruling 2009-13, the ruling concluded that this transaction is governed by the rules dealing with sales or other dispositions of property. For purposes of determining basis, the ruling found that the transfer for value rules are not relevant, as those provisions apply only to amounts received by reason of the death of the insured. The analysis does not mention the investment in the contract rules.

Instead, similar to Revenue Ruling 2009-13, it analyzes the cost of the life insurance policy. The similarity to that ruling ends there, however, as Revenue Ruling 2009-14 applies regulations relating to capitalization of amounts paid to acquire intangible assets.[15] Accordingly, it determined that the cost of the life insurance policy included the $20,000 purchase price paid to the original owner plus the additional $9,000 in premiums paid before the resale. The ruling stated that the additional premiums should be capitalized even though such amounts are disallowed as a deduction under section 264. It reasoned that the premiums paid by a secondary market purchaser on a term insurance contract serves "to create or enhance a future benefit for which capitalization is appropriate."

Revenue Ruling 2009-14 concludes that a secondary purchaser is not required to reduce the premium amounts paid by cost of insurance charges collected by the insurance company during the time the secondary owner held the contract. It reasoned that the purchaser did not buy the life insurance contract for protection against any economic loss upon the insured's death. It found that instead, the secondary market purchaser acquired the contract solely with a view towards profit and that it paid the additional premiums to prevent the lapse of its purely financial investment in the contract.

While the ruling ends up with what is arguably the correct result, for the reasons set forth in the above discussion of Revenue Ruling 2009-13, the rationale it provides would seem to be equally applicable to many original purchasers of life insurance contracts, individual and nonindividual owners alike.

Character of Gain on Sale

The gain of $1,000 (*i.e.*, $30,000 sales proceeds less the $29,000 original purchase price and additional premiums paid) is treated as a long-term capital gain because the contract is a capital asset under section 1221 and was held for more than one year.

As an interesting note, the ruling expressly states that the "Service will not challenge the capitalization of such premiums paid or incurred prior to the issuance of this ruling." This may reassure some investors that purchased life insurance contracts prior to this ruling as to the IRS's view of calculating basis.

SITUATION 3

The third and final situation presented in the ruling is similar to that in Situation 1, but involves a foreign corporation as the purchaser of the level premium 15-year term life insurance contract. The foreign corporation 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 information is given as a fact but it would have been helpful to see the process of determining whether or not a foreign corporation is engaged in a U.S. trade or business. Whether a life settlement structure may be a trade or business is a key question in determining the tax treatment of a foreign investor. It will have an impact on determining where the income is sourced, as well as whether amounts paid to the entity will be subject to withholding. The mere fact, however, that the ruling acknowledges that investing in life settlements can be a trade or business—as opposed to an investment—is itself, a key piece of guidance.

Fixed or Determinable Annual or Periodical Income?

The ruling states that the amount of income recognized from the death benefit is the same $71,000 as under situation one and is "fixed or determinable annual or periodical income" (FDAP) within the meaning of section 881(a)(1). The IRS references various pieces of guidance as support for the treatment of the death benefit as FDAP, including regulation section 1.1441-2(b), Revenue Ruling 64-51, and Revenue Ruling 2004-75. The regulation and rulings, however, do not specifically mention death benefits.

For example, Revenue Ruling 2004-75 concludes that income received by a nonresident alien individual under life and annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S. source FDAP income. The ruling does not address death benefit payments. Instead, it compares the income received under a life insurance or annuity contract as it relates to an investment return on the cash value of the contract to interest on a debt obligation or dividends on a stock.

The second ruling cited in support of its conclusion that death benefits are FDAP is Revenue Ruling 64-51. Revenue Ruling 64-51 cites regulation 1.1441-2(a), which has been amended since the time of the 1964 ruling, and which states that "income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained." The 1964 ruling concludes:

> Generally, the company issuing the life insurance policy can predetermine and has a basis of calculation to ascertain the amounts to be paid to and the income to be included in the cash surrender value or the maturity value of such a policy. Therefore, the income realized upon the surrender or maturity of a life insurance policy comes within the definition of the term "fixed or determinable annual or periodical income."

Based on this language, it would appear that death benefits, which for a term life insurance contract would represent the maturity of the contract, could arguably be considered FDAP. Absent the above citations, however, Revenue Ruling 2009-14 does not provide any analysis in furtherance of its conclusion that a death benefit paid by a U.S. insurer to a foreign corporation on a U.S. insured is FDAP.

Doing so would have been helpful given the existence of authorities that potentially conflict with the 1964 ruling. As discussed in the February 2009 article, the regulations provide a description of items of income that are not FDAP. More precisely, regulation section 1.1441-2(b)((2) states that "[g]ains derived from the sale of property" are not FDAP. That is, one could envision an argument that the payment of a death benefit is a disposition, similar to a sale, and that such income would fall under the FDAP exclusion for gains derived from the sale of property.

Source of Income

For purposes of determining the source of the death benefit as either U.S. or foreign, the ruling finds that when the source of income is not specified by statute or regulation, the courts have determined the source of the item by comparison and analogy to other classes of income specified in the statute. The ruling mentions to section 861(a)(1) and (7). Section 861(a)(1) provides that interest received from a domestic corporation is generally from sources within the U.S. Comparison to section 861(a)(1) would arguably seem reasonable when attempting to source payments made under a life insurance contract related to earnings reflected in the cash value of the contract. The comparison with respect to the source of death benefits, however, does not seem nearly as relevant. Section 861(a)(7) provides that amounts received as underwriting income from the issuing of insurance or annuity contracts on the lives of U.S. residents would be considered gross income from sources within the United States. The ruling does not explain how this type of income compares, or may be analogized to a death benefit.

The IRS also makes a single-sentence reference to section 865, which provides that the source of income from the sale of personal property is generally sourced to the residence of the taxpayer. No further discussion is given regarding section 865.

Life insurance has long been recognized as personal property.[16] Section 865(i)(2), as discussed in the February 2009 Article, defines the term "sale" to include "an exchange, or any other disposition." It would seem from this language that a sale of a life insurance contract by the foreign corporation would be considered foreign source income. The ruling, however, does not include a sale of a life insurance contract by a foreign purchaser as one of the scenarios discussed. The third situation involves a death benefit payment to a foreign corporation which arguably could be viewed as an "other disposition" under section 865(i)(2). If that were the case, the source of the death benefit would be foreign, not U.S.[17]

CONTINUED ON PAGE 36

Frederic Gelfond is a principal with the Washington, D.C. National Tax office of Deloitte Tax LLP and may be reached at *fgelfond@deloitte.com.*

Yvonne S. Fujimoto is insurance tax senior manager with the Washington, D.C. National Tax office of Deloitte Tax LLP and may be reached at *yfujimoto@deloitte.com.*

As previously mentioned, the ruling does not fully describe its analysis of section 865 and simply concludes that the foreign purchaser will recognize $71,000 of ordinary income from sources within the United States that will apparently be subject to withholding tax under section 881(a)(1). Further discussion of its analysis with respect to the third scenario would have been helpful to taxpayers trying to structure their transactions in accordance with the very complex regime in place for taxing foreign investors, and for ensuring that domestic entities with payment obligations act in accordance with the various withholding requirements.

CONCLUSION

Anyone, whether an individual or a corporation, with a life insurance contract that they may no longer need, or who is in greater need of the cash that the contract represents than the insurance coverage it offers, or an investor in the life settlements business is appreciative of whatever tax guidance the IRS can offer with respect to the sale, purchase, and holding of a life insurance contract. Both of the revenue rulings discussed herein are helpful in providing insight into their positions relative to calculating basis, the amount of income to be recognized, and the character of that income. In some instances, taxpayers may have questions as to the appropriateness of the answers or may still have questions that remain unanswered. As stated at the outset of this article, those participating in the life settlements business have been looking for answers. Some answers have now been provided, but the life settlements industry participants are looking for more. *If you give a mouse a cookie . . .*

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates and related entities, shall not be responsible for any loss sustained by any person who relies on this publication.

Copyright © 2009 Deloitte Development LLC.
All rights reserved.

END NOTES

1. *If You Give a Mouse a Cookie*, by Laura Joffe Numeroff.
2. Frederic J. Gelfond, "Selected Insurance and International Tax Considerations for Investors in Life Settlement Businesses," *TAXING TIMES*, February 2009, Vol. 5, Issue 1.
3. Internal Revenue Code of 1986, as amended (Code). Unless otherwise indicated, all section references are to the Code.
4. Section 101(a)(2).
5. Section 101(a)(1).
6. Section 264(a)(1).
7. See section 72(e).
8. Section 1223(3).
9. Per section 1221(a), a capital asset is property held by a taxpayer that is not one of the items listed in section 1221(a)(1)-(8).
10. *Century Wood Preserving Co. v. Commissioner*, 69 F.2d 967 (3rd Cir. 1934); *Keystone Consolidated Publishing v. Commissioner*, 26 B.T.A. 1210 (1932); *London Shoe Co. v. Commissioner*, 80 F.2d 230, 231 (2nd Cir. 1935).
11. *Gallun v. Commissioner*, 327 F.2d 809 (7th Cir. 1964).
12. *First National Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962), at 588.
13. *Commissioner v. Phillips*, 275 F.2d 33 (4th Cir. 1960); *First National Bank of Kansas City v. Commissioner*, 309 F.2d 587 (8th Cir. 1962); Gallun v. Commissioner, 327 F.2d 809 (7th Cir. 1964).
14. Purchaser is a United States person as defined in section 7701(a)(30).
15. Essentially, it applies the rules under regulation section 1.263(a)-4(c)(1)(iv).
16. *See, e.g., Lucas v. Alexander*, 279 U.S. 573 (1929).
17. Section 865(e)(2) provides that if a foreign entity maintains an office or other fixed place of business in the United States, the income from the sale of personal property attributable to such office or other fixed place of business shall be sourced in the United States.