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IRS Issues Rulings Addressing Secondary Market Transactions in Life Insurance

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Over the years, a substantial secondary market in life insurance contracts has developed, giving individuals owning these contracts what may be an important source of income, and allowing investors to gain exposure to a new asset class. Investors may purchase policies directly or through an investment vehicle such as a limited partnership. The Internal Revenue Service ("IRS") has now issued two published rulings that will help clarify the tax treatment of transactions in this market. The rulings clarify the tax treatment of both the original owner of the contract and the investor in the secondary market. The rulings do not address the special rules applying to viatical settlements in which a policy is sold by certain terminally ill or chronically ill individuals.

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The rulings build on the basic statutory rule for tax treatment of life insurance policies. Under that rule, gross income does not include amounts received under a life insurance contract if such amounts are paid by reason of the death of the insured. However, in the case of a transfer of a life insurance contract for valuable consideration, unless an exception applies, the amount excluded by the transferee may not exceed the sum of the consideration paid and the premiums and other amounts subsequently paid by the transferee.

Tax Consequences to the Original Holder

Rev. Rul. 2009-13 ruled on the tax consequences to the original holder of a policy. The IRS determined that if the original holder surrenders the policy for its cash surrender value, the amount received is included in gross income to the extent it exceeds the "investment in the contract". For a holder who has neither received distributions nor borrowed against the cash surrender value, the investment in the contract will generally be the amount of premiums paid. The IRS ruled that the income on surrender will be ordinary income, despite the enactment of Section 1234A, which generally provides that gain or loss on the termination of a right or obligation with respect to a capital asset will be treated as gain or loss from the sale of the asset.

If the holder sells the policy to an unrelated person instead of surrendering it, the IRS, citing old case law,

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takes the position that the holder's basis in the policy does not include the total amount paid as premiums, since some part of those premiums was paid for continuing insurance protection, and the part of the premiums which paid for insurance protection was earned and used. Thus, the insured holder will recognize a greater gain (or smaller loss) on the sale of a policy because of the inability to include in basis all of the premiums paid. Moreover, on a sale of a policy with a cash surrender value, under what the IRS refers to as the "substitute for ordinary income doctrine", a portion of the gain will be ordinary income equal to the amount that would be ordinary income if the contract were surrendered, i.e., the inside build-up under the contract. Thus, the gain is bifurcated between ordinary income and capital gain, although the ruling assumes that the policy is a capital asset in the hands of the holder.

In the case of term policies, where the holder has paid for insurance protection without an investment component, the insured is likely to have little or no basis in the policy, and the IRS states that for a level premium term contract with no cash surrender value, absent other proof, the cost of the insurance is presumed to equal the monthly premium under the contract. Presumably, the only basis available will be for premiums paid for coverage not yet provided. However, because there is no cash surrender value and no inside build-up, there will be no ordinary income on the sale under the "substitute for ordinary income doctrine" according to the ruling.

The IRS provides that its holdings in the ruling with respect to sales of policies to an unrelated purchaser will not be applied adversely to sales occurring before August 26, 2009.

Tax Consequences to a Purchaser in the Secondary Market

Rev. Rul. 2009-14 ruled on the tax consequences to a purchaser in a secondary market of a term life insurance policy with no cash surrender value. Such a secondary market purchaser will generally purchase in a "transfer for a valuable consideration". Thus, the purchaser may not exclude from gross income on receipt of death benefits amounts in excess of the sum of the consideration paid and the premiums and other amounts subsequently paid by the transferee. Moreover, although the ruling assumes that the life insurance contract is a capital asset in the hands of the purchaser, neither the surrender of a contract nor the receipt of death benefits from the issuer is a sale or exchange. Accordingly, the amount recognized upon the receipt of death benefits will generally be ordinary income.

The ruling provides that as premiums paid by a purchaser in the secondary market serve to create or enhance a future benefit, the purchaser must capitalize such premiums paid, and if the purchaser sells the contract, the basis against which income is measured will therefore include such premiums paid as well as the amount paid to the original holder. Because the policy was purchased for profit, no reduction is required for the cost of insurance protection, as is the case for the original holder. Since the term policy does not have cash surrender value, there is no ordinary income under the "substitute for ordinary income doctrine". Thus, in the case of purchasers in the secondary market, there is a potential rate advantage in selling the policies prior to death of the insured, although such sale will accelerate the recognition of income.

Lastly, the ruling provides that in the case of a foreign purchaser in the secondary market not engaged in a U.S. trade or business, death benefit income will be "fixed and determinable annual or periodical income", subject to a withholding tax if the payments are U.S. source. Although the Code does not specify the source of income resulting from the payment of death benefits, where the insured is a U.S. citizen residing in the U.S., and the issuing corporation is a domestic corporation, the income of the foreign purchaser will be income from sources within the U.S., subject to U.S. withholding tax.

Conclusion

The rulings provide important guidance to both sellers and purchasers of life insurance contracts, but leave many unanswered questions, including the treatment of interest incurred on the financing of policies, the tax consequences to a purchaser in a secondary market of life insurance contracts that are whole life or universal life policies, and the circumstances in which the holding of insurance policies may be deemed to constitute a U.S. trade or business.

For example, it is unclear to what extent the IRS would permit purchasers to capitalize interest on indebtedness incurred to purchase the policy as part of their basis or the extent to which purchasers of

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whole life or universal life policies would be taxable on distributions of all or a portion of the cash surrender value of a purchased policy.

In addition, taxpayers will need to determine whether any of the positions taken by the IRS, including the reduction to basis for the cost of insurance protection, may be distinguished on the facts, or challenged in the courts. The Federal Tax group at Morrison & Foerster LLP will continue to monitor developments in this area.

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