

# The GIBSON&PERKINS Tax Letter

---

CIRCULATED TO TAX ADVISORS AND CLIENTS

June 3, 2009

## IRS Rules on Tax Aspects of Sale of Life Insurance Policies

### OVERVIEW

In Revenue Ruling 2009-13 and Revenue Ruling 2009-14, the IRS has ruled on the tax aspects to both Buyer and Seller of the sale of a Life Insurance Policy to a third party. The sale and purchase of Life Insurance Policies remains a viable business within limitations related to insurable interest.

### CONSEQUENCES TO THE SELLER OF POLICY

Revenue Rule 2009 - 13 describes three sets of circumstances.

**Situation One:** Surrender of Policy To Insurer.

**Result:** Ordinary Income to Seller.

An individual had purchased a Life Insurance Policy on his life and named as beneficiary a member of his family. Seven years later, the individual surrendered the policy in exchange for a payment of \$78,000.00, which reflects the subtraction by the insurance company of \$10,000.00, cost of insurance charged through date of surrender he had received. The insured had paid \$64,000.00 in premiums through the sale and surrender and no other distribution with respect to the policy.

The insured recognized ordinary income of \$14,000.00 (\$78,000.00 surrender value less \$64,000.00 premium paid) and the surrender of the life insurance policy does not produce capital gain.

**Situation Two:** Insurer Sold Policy to Unrelated Third Party.

**Result:** Part Ordinary income; Part Capital Gain.

The insured paid \$64,000.00 in premium and \$10,000.00 of cost of insurance charges but sold the policy for \$80,000.00 charges of surrender to the carrier.

The IRS ruled the premiums of \$64,000.00 must be reduced by the cost of insurance to produce a basis of \$54,000.00, which results in recognition of \$26,000.00 income on the transaction. The IRS ruled that subtracting the premiums paid of \$64,000.00 from

the cash surrender value resulted in an amount of \$14,000.00, treated as ordinary income under the “Substitute for Ordinary Income” Doctrine. The balance of the income, \$12,000.00, could be treated as a capital gain.

**Situation Three:** Sale of Term Life Policy To Unrelated Third Party.

**Result:** Long Term Capital Gain

The policy was a 15 year level Premium Term Life Insurance Policy. The insured paid premiums of \$45,000.00 and in the eighth year of ownership sold the policy to an unrelated third party for \$20,000.00. The premium paid monthly, was presumed to be equal to the cost of insurance.

In this case, the policy was sold in the middle of the month, so only \$250.00 (one-half month’s premium) of the \$45,000.00 paid was not part of the cost of insurance. The basis of the policy was \$250.00 and the income recognized was \$19,750.00 (\$20,000 less \$250.00) and the income was long-term capital gain.

The ruling will not be applied to sales occurring before August 26, 2009.

### **CONSEQUENCES TO THE BUYER**

Revenue Ruling 2009-14 also considered three situations involving the purchase of a life insurance policy.

**First Situation:** Purchase of 15 year level Premium Term.

**Result:** Ordinary income

An individual purchased for \$20,000.00 a 15 year Level Term life insurance policy from the owner, also the insured. The continuing premium was \$500.00 per month. The buyer paid an additional \$9,000.00 in premiums at which point the insured died and the new owner received the \$100,000.00 in death benefits as the new beneficiary.

The IRS referred to Section 101(a) which exempts most payments of insurance policy proceeds but noted Section 101(a) only applied in this case to the extent of the \$20,000.00 purchase price and the additional \$9,000.00 of premiums paid because of the application of transfer for value.

The \$71,000.00 (\$100,000.00 death benefit less \$20,000.00 purchase price and \$9,000.00 of additional premiums) was ordinary income.

**Second Situation::** Buyer of Level Term Policy Resells to Unrelated Third Party.

**Result:** Capital Gain

The buyer of a policy paid \$20,000.00 and \$9,000.00 of additional premiums then re-sold it to an unrelated third party for \$30,000.00. The additional premiums were to be capitalized and added to the basis.

The buyer was not required to reduce the basis by the cost of insurance because unlike the owner/insured in Revenue Rule 2009-13, the buyer did not acquire the policy to protect against any economic loss on the death but only as a profit making investment. The Ordinary Income Rule did not apply as there was no cash value.

The \$1,000.00 of income was Capital Gain.

**Third Situation:** Buyer is a Foreign Corporation.

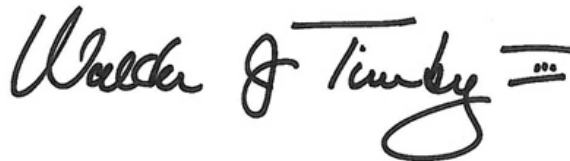
**Result:** Tax Imposed Under §881(a)(i) – Tax on Income of Foreign Corporation

The facts of the First Situation were changed to a buyer who was a foreign corporation, not engaged in a trade of business in the United States. The buyer had to recognize \$71,000.00 of income when the death benefits were received. Since the foreign corporation was not engaged in business in the United States, the income would be taxable in the United States only if it were a United States source income.

The IRS ruled the income received was income received from United States sources, the insured was a United States citizen and the insurance company was a domestic corporation.

Tax was imposed under Section 881(a)(1) at the rate of 30 percent for the death benefit.

Regards,

A handwritten signature in black ink that reads "Walter J. Timby, III". The signature is written in a cursive style with a horizontal line above the name and a double horizontal line below it.

Walter J. Timby, III

**GIBSON&PERKINS, PC**  
100 W. Sixth Street, Suite 204  
Media, Pennsylvania 19063  
www.gibperk.com - (610) 565-1708