

Part I

Section 72.—Annuities; certain proceeds of endowment and life insurance contracts
(Also §§ 1001, 1011, 1012, 1221, and 1234A)

Rev. Rul. 2009-13

ISSUE

What is the amount and character of A's income recognized upon the surrender or sale of the life insurance contracts described in the situations below?

FACTS

Situation 1

On January 1 of Year 1, A, an individual, entered into a “life insurance contract” (as defined in § 7702 of the Internal Revenue Code (Code)) with cash value. Under the contract, A was the insured, and the named beneficiary was a member of A's family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract in A's hands was not property described in § 1221(a)(1)-(8).

On June 15 of Year 8, A surrendered the contract for its \$78,000 cash surrender value, which reflected the subtraction of \$10,000 of “cost-of-insurance” charges collected by the issuer for periods ending on or before the surrender of the contract. Through that date, A had paid premiums totaling \$64,000 with regard to the life insurance contract. A had neither received any distributions under the contract nor borrowed against the contract’s cash surrender value.

A determines taxable income using the cash method of accounting and files income tax returns on a calendar year basis. As of June 15 of Year 8, A was not a terminally ill individual, nor a chronically ill individual, within the meaning of § 101(g)(4).

Situation 2

The facts are the same as in Situation 1, except that on June 15 of Year 8, A sold the life insurance contract for \$80,000 to B, a person unrelated to A and who would suffer no economic loss upon A’s death.

Situation 3

The facts are the same as in Situation 1, except that the contract was a level premium fifteen-year term life insurance contract without cash surrender value. The monthly premium for the contract was \$500. Through June 15 of Year 8, A paid premiums totaling \$45,000 with regard to the contract. On June 15 of Year 8, A sold the life insurance contract for \$20,000 to B, a person unrelated to A and who would suffer no economic loss upon A’s death.

LAW AND ANALYSIS

SITUATION 1Amount of income recognized upon surrender of the life insurance contract

Section 61(a) provides that, except as otherwise provided in the income tax provisions of the Code, gross income includes all income from whatever source derived, including (but not limited to) income from life insurance contracts. See § 61(a)(10). To the extent that another section of the Code or regulations provides specific treatment of any item of income, that other provision applies notwithstanding § 61 and the regulations thereunder. See § 1.61-1(b) of the Income Tax Regulations.

Section 72(e) governs the federal income tax treatment of amounts received under an annuity, endowment, or life insurance contract that are not received as an annuity. In general, under § 72(e)(2), a non-annuity amount that is received on or after the annuity starting date is included in gross income. If a non-annuity amount is received before the annuity starting date, it is included in gross income to the extent allocable to income on the contract, but not to the extent allocable to investment in the contract (i.e., it is taxed on an income-first basis).

Section 72(e)(5) provides an exception to the income-first rule in the case of — (1) certain contracts including, under § 72(e)(5)(C), life insurance contracts other than a “modified endowment contract” (as defined in § 7702A) and (2) any non-annuity amount received under a contract on its complete surrender, redemption, or maturity.

If a non-annuity amount is received under a life insurance contract other than a modified endowment contract before the annuity starting date, or is received under a life

insurance contract on the complete surrender, redemption, or maturity of the contract, § 72(e)(5)(A) requires that the amount be included in gross income but only to the extent it exceeds investment in the contract. For this purpose, § 72(e)(6) defines "investment in the contract" as of any date as the aggregate amount of premiums or other consideration paid for the contract before that date, less the aggregate amount received under the contract before that date to the extent that amount was excludable from gross income.

In Situation 1, A received \$78,000 on the complete surrender of a life insurance contract. A's income upon surrender of the contract is determined under § 72(e)(5). Under § 72(e)(5)(A), the amount received is included in gross income to the extent it exceeds the investment in the contract. As A paid aggregate premiums of \$64,000 with regard to the contract, and neither received any distributions under the contract nor borrowed against the contract's cash surrender value prior to surrender, A's "investment in the contract" as required by § 72(e)(6) was \$64,000. Consequently, pursuant to § 72(e)(5)(A), A recognized \$14,000 of income on surrender of the contract, which is the excess of \$78,000 received over \$64,000.

Character of income recognized upon surrender of the life insurance contract

Section 72(e) does not specify whether income recognized upon the surrender of a life insurance contract is treated as ordinary income or as capital gain. Thus, the character of the income that A recognized on the surrender of the life insurance contract is capital gain only if it so qualifies under the general rules of subchapter P (§§ 1201-1260).

Section 1222(3) defines long-term capital gain as gain from the sale or exchange of a capital asset held for more than one year, if and to the extent such gain is taken into account in computing gross income. Section 1221(a) provides that the term "capital asset" means property held by the taxpayer (whether or not connected with a trade or business), but does not include items described in § 1221(a)(1)-(8). As noted above, the life insurance contract was not property described in § 1221(a)(1)-(8).

The surrender of a life insurance contract does not, however, produce a capital gain. See, e.g., Rev. Rul. 64-51, 1964-1 C.B. 322 (noting that "[u]nder section 61(a)(10) of the Code, the proceeds received by an insured upon the surrender of, or at maturity of, a life insurance policy constitutes ordinary income to the extent such proceeds exceed the cost of the policy"). Section 1234A, originally enacted in 1981, does not change this result.

Accordingly, in Situation 1 the \$14,000 of income recognized by A on the surrender of the life insurance contract is ordinary income.

SITUATION 2

Amount of income recognized on sale of the life insurance contract

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain realized from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain. Thus, to determine the amount of A's income from the sale

of the life insurance contract in Situation 2, it is necessary to determine A's amount realized from the sale, and A's adjusted basis in the contract.

Pursuant to § 1001(b), A's amount realized from the sale of the life insurance contract is the sum of money received from the sale, or \$80,000.

Under §§ 1011 and 1012, the adjusted basis for determining gain or loss is generally the cost of the property adjusted as provided in § 1016, except as otherwise provided in subchapters O (§§ 1011 through 1092), C (§§ 301 through 386), K (§§ 701 through 777), and P (§§ 1201 through 1298). See also § 263(a); § 1.263(a)-4. Under § 1016(a)(1), proper adjustment must be made for expenditures, receipts, losses, or other items properly chargeable to capital account. See also § 1.1016-2(a). Section 72 has no bearing on the determination of the basis of a life insurance contract that is sold, because § 72 applies only to amounts received under the contract.

Both the Code and the courts acknowledge that a life insurance contract, although a single asset, may have both investment characteristics and insurance characteristics. See, e.g., § 7702 (defining life insurance contract for federal income tax purposes by reference, in part, to both the cash surrender value and death benefits under the contract); London Shoe Co. v. Commissioner, 80 F.2d 230, 231 (2d Cir. 1935) ("A life insurance policy ordinarily combines investment with insurance protection."); Century Wood Preserving Co. v. Commissioner, 69 F.2d 967, 968 (3d Cir. 1934) ("The policies of insurance involved here have a double aspect. They provide the present protection of ordinary life insurance and also a means of investment."). To measure a taxpayer's gain upon the sale of a life insurance contract, it is necessary to reduce basis

by that portion of the premium paid for the contract that was expended for the provision of insurance before the sale.

In Century Wood Preserving Co. v. Commissioner, 69 F.2d 967 (3d Cir. 1934), a corporate taxpayer paid \$98,242 of premiums on life insurance contracts over a period of several years to insure the lives of its officers. The taxpayer then sold the contracts to the officers for their cash surrender value of \$57,646, claiming a loss for the difference between the total premiums paid and the amount for which it sold the contracts. The court held that the taxpayer did not have a loss, because it did not have a basis equal to the full amount of the premiums paid:

If the [taxpayer] is entitled to a deduction from gross income, it is because [it has] sustained a loss, the basis of determining which is the cost of the property. ... The cost of an asset is the real question here. It is obvious that cost is not the total amount paid in as premiums, since continuing insurance protection is part of the consideration for the contract. The part of the premiums which represents annual insurance protection has been earned and used. 69 F.2d at 968.

See also London Shoe Co., 80 F.2d at 233 (noting, in the context of a situation in which the policy was surrendered, not sold, that "the cost [of the policy] was approximately reflected in the cash surrender value ... [t]he portion of the premiums not used to build up the reserve was paid to obtain insurance protection which was for many years afforded."); Keystone Consolidated Publishing Co. v. Commissioner, 26 B.T.A. 1210, 1211 (1932) (stating "[t]otal premiums paid did not represent the cost of the [life insurance contract]. . . . [t]o so hold would be to disregard the element of insurance protection in the period prior to the sale, the benefit of which accrued to petitioner."); § 1.1016-2(a) (cost or other basis of property adjusted for any expenditures, receipts,

losses or other items properly chargeable to capital account). Compare Rev. Rul. 2009-14, page ____, this Bulletin (not requiring a reduction for cost of insurance charges imposed after a preexisting life insurance contract was purchased for profit by a taxpayer with no insurable interest in the insured).

In Situation 2, A paid total premiums of \$64,000 under the life insurance contract through the date of sale, and \$10,000 was subtracted from the contract's cash surrender value as cost-of-insurance charges. Accordingly, A's adjusted basis in the contract as of the date of sale under §§ 1011 and 1012 and the authorities cited above was \$54,000 (\$64,000 premiums paid less \$10,000 expended as cost of insurance).

Accordingly, A must recognize \$26,000 on the sale of the life insurance contract to B, which is the excess of the amount realized on the sale (\$80,000) over A's adjusted basis of the contract (\$54,000).

Character of income recognized on sale of the life insurance contract

Unlike Situation 1, which involves the surrender of the life insurance contract to the issuer of the contract, Situation 2 involves an actual sale of the contract. Nevertheless some or all of the gain on the sale of the contract may be ordinary if the substitute for ordinary income doctrine applies.

The Supreme Court has held, under the so-called "substitute for ordinary income" doctrine, that "property" within the meaning of § 1221 does not include claims or rights to ordinary income. Instead, the Court "has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income." United States v. Midland-Ross Corp., 381

U.S. 54, 57 (1965). See also Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (consideration received on the sale of a working interest in an oil well represented a substitute for what would have been received in the future as ordinary income, therefore taxable as ordinary income and not capital gain); Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 217, n.5 (1988) (noting that the “substitute for ordinary income” doctrine had no application to that case). Thus, ordinary income that has been earned but not recognized by a taxpayer cannot be converted into capital gain by a sale or exchange. See also Prebola v. Commissioner, 482 F.3d 610 (2d Cir. 2007); United States v. Maginnis, 356 F.3d 1179 (9th Cir. 2004); Davis v. Commissioner, 119 T.C. 1 (2002) (applying the “substitute for ordinary income” doctrine after the Arkansas Best decision).

The "substitute for ordinary income" doctrine has been applied to characterize the profit on a sale of an annuity contract or life insurance contract as ordinary income. For example, in Gallun, 327 F.2d 809, 811 (7th Cir. 1964), the court stated:

The question presented has been considered by other courts. Uniformly, they have held that the assignment of income doctrine . . . should be applied and the profits realized from the sale or the surrender value of an annuity or life insurance contract should be treated as ordinary income rather than capital gain. These cases are: First Nat'l Bank of Kansas City v. Commissioner, 309 F.2d 587 (8th Cir. 1962); Rolf v. Commissioner, 304 F.2d 450 (3d Cir. 1962); Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960); Arnfeld v. United States, 163 F. Supp. 865, 143 Ct. Cl. 277 (1958).

Application of the “substitute for ordinary income” doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., to the inside build-up under the contract). Hence, if the income recognized on the sale or exchange of a life insurance contract exceeds the “inside build-up” under the

contract, the excess may qualify as gain from the sale or exchange of a capital asset. See, e.g., Commissioner v. Phillips, 275 F.2d 33, 36 n. 3 (4th Cir. 1960).

In Situation 2, the inside build-up under A's life insurance contract immediately prior to the sale to B was \$14,000 (\$78,000 cash surrender value less \$64,000 aggregate premiums paid). Hence, \$14,000 of the \$26,000 of income that A must recognize on the sale of the contract is ordinary income under the "substitute for ordinary income" doctrine. Because the life insurance contract in A's hands was not property described in § 1221(a)(1)-(8) and was held by A for more than one year, the remaining \$12,000 of income is long-term capital gain within the meaning of § 1222(3).

SITUATION 3

Amount of income recognized on sale of the term life insurance contract

In Situation 3, the amount realized from the sale of the term life insurance contract is the sum of money received from the sale, or \$20,000.

A's adjusted basis in the life insurance contract for purposes of determining its gain or loss on sale is equal to the total premiums paid under the contract, less charges for the provision of insurance before the sale. Absent other proof, the cost of the insurance provided to A each month is presumed to equal the monthly premium under the contract, or \$500. The cost of the insurance protection provided to A during the 89.5 month period that A held the contract was \$500 times 89.5 months, or \$44,750. Hence, A's adjusted basis in the contract on the date of the sale to B was \$250 (\$45,000 total premiums paid, less \$44,750 cost of insurance protection).

Accordingly, A must recognize \$19,750 on the sale of the term life insurance contract to B in Situation 3, which is the excess of the amount realized on the sale (\$20,000) over the adjusted basis of the contract (\$250).

Character of income recognized on sale of the term life insurance contract

In Situation 3, the term life insurance contract had no cash surrender value. Hence, there was no inside buildup under the contract to which the substitute for ordinary income doctrine could apply. Because the life insurance contract in A's hands was not property described in § 1221(a)(1)-(8) and was held by A for more than one year, the \$19,750 of income that A must recognize on the sale of the contract is long-term capital gain within the meaning of § 1222(3).

HOLDINGS

1. In Situation 1, A must recognize \$14,000 of ordinary income upon surrender of the life insurance contract.

2. In Situation 2, A must recognize \$26,000 of income upon sale of the life insurance contract. Of this \$26,000 of income, \$14,000 is ordinary income, and \$12,000 is long-term capital gain.

3. In Situation 3, A must recognize \$19,750 of long-term capital gain upon sale of the life insurance contract.

EFFECTIVE DATE

Under the authority of § 7805(b)(8), the holdings of this revenue ruling with respect to Situations 2 and 3 will not be applied adversely to sales occurring before August 26, 2009.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Josephine H. Firehock of the Office of Associate Chief Counsel (International) and Stephen D. Hooe of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this ruling, contact Stephen D. Hooe at (202) 622-3970 (not a toll-free call).