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Taxation of Surrender or Sale of Life Insurance Policy

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The IRS, in recently-issued Revenue Rulings (Rev. Rul.) 2009-13 and 2009-14, has provided much needed guidance regarding a number of tax issues pertaining to life insurance surrenders and sales of policies to unrelated third parties.

Rev. Rul. 2009-13, by way of three examples, sets forth rules for taxing the transferor of a policy. Situation One confirms the generally accepted view that, upon the surrender of a policy, the surrender proceeds in excess of basis (generally total premiums paid) is taxed as ordinary gain. The example provided is as follows:

Cash surrender value	$78,000
Total Premiums	($64,000)
Ordinary gain	$14,000

Situation Two addresses the sale of a cash value policy, typically in the secondary market (e.g., to a life settlement company), and contains both good news and bad news for the seller. The good news is

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that the portion of the gain in excess of the ordinary gain had the policy been surrendered is taxed as capital gain. The bad news is that basis (generally total premiums) must be reduced by the cost of pure life insurance protection, with no guidance provided regarding how to calculate the cost of pure life insurance protection. The example provided is as follows:

1. Sale proceeds = $80,000;
2. Cash surrender value = $78,000;
3. Premiums paid (basis) = $64,000;
4. Less cost of insurance = ($10,000);
5. Adjusted basis = $54,000 (No. 3 – No. 4);
6. Gain = $26,000 (No. 1 - No. 5);
7. Ordinary income portion of gain = $14,000 (No. 2 – No. 3);
8. Capital gain portion = $12,000 (No. 6 – No. 7).

Situation Three addresses the sale of a term insurance policy. As in Situation Two, the basis (total premiums paid) must be reduced by the cost of life insurance protection. Here, however, the cost of life insurance protection is presumed to be the entire premium in the absence of proof to the contrary, thereby resulting in an adjusted basis of zero or a minimal amount. The ruling holds that the sale proceeds in excess of adjusted basis are taxed as capital gain. The example provided is as follows:

1. Sale proceeds = $20,000;
2. Premiums paid (basis) = $45,000;
3. Cost of insurance = ($44,750);
4. Adjusted basis = $250 (No. 2 – No. 3);
5. Capital gain = $19,750 (No. 1 – No. 4).

Rev. Rul.2009-14, again by way of the three examples, addresses the taxation of the purchaser of a policy upon the subsequent death of the insured or the resale of the policy. Situation One holds that the death benefit in excess of basis (purchase price for the policy plus premiums subsequently paid by the purchaser) is taxed as ordinary gain. This situation can arise unexpectedly in numerous situations which are deemed to be "transfers for value" (e.g., when policies owned by a corporation to fund a stock redemption agreement are transferred to the shareholders to fund a cross-purchase agreement). The exceptions to the transfer-for-value rule are beyond the scope of this article.

Situation Two addresses the resale of the policy by the original buyer. The sale proceeds in excess of premiums paid are taxed as capital gains. However, unlike Situation Two in Rev. Rul. 2009-13 total premiums paid need not be reduced by the cost of pure life insurance protection, because the purchaser would not have benefited from the pure life insurance protection had the insured died prior to selling the policy.

Situation Three holds that, if the purchase is a foreign corporation, the tax result at the insured's death is the same as for Situation One, and the gain is subject to U.S. income taxes.

By issuing Rev. Ruls. 2009-13 and 2009-14, the IRS has removed much of the prior uncertainty surrounding the taxation of sales of life insurance polices, especially in the secondary market.

Mr. Miller is a member of the Firm and a former financial planner who practices in the areas of estate planning, probate, elder law, business law, taxation and qualified retirement plans. Should you have any questions regarding these rules, please contact Mr. Miller (419-241-6000).