2009 Revenue Rulings Give Seniors and the Life Settlement Industry A Few Answers, But More Questions

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Insurance Studies Institute is a non-profit foundation dedicated to advancing knowledge and understanding of the insurance industry's economic and social impacts in a free market economy.

This is the second in a series of papers addressing taxation associated with both traditional and evolving third party life insurance transactions. It examines new IRS Revenue Rulings, issued in 2009, which attempt to resolve numerous gaps in prior tax law applicable to life settlements and taxation of life insurance policy death benefits. This paper focuses on several common tax scenarios and does not attempt to address all possible taxable scenarios resulting from life insurance transactions. ***This paper does not provide any tax or legal advice and should not be relied upon for purposes of determining individual tax liabilities.***

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On March 3, 2008, Insurance Studies Institute ("ISI") published a paper on taxation of life insurance policies ("2008 ISI Taxation Paper"). In that paper, ISI noted: "As a result of the rapidly evolving secondary marketplace for life insurance, the taxation of life insurance transactions and computation of a life insurance policy tax basis has become increasingly important. Yet, the proper taxation of life settlement and premium finance transactions is not entirely clear and the Internal Revenue Code fails to provide a methodology for the proper tax basis calculation when the policy is sold to a third party."[1]

Subsequently, on April 6, 2009, Senator Herb Kohl (D-WI), Chairman of the Senate's Special Committee on Aging, wrote to Treasury Secretary Timothy Geithner requesting clarification of the tax treatment of transactions within the life settlement market.[2] Days later,[3] the IRS ("Service") issued Revenue Rulings 2009-13 and 2009-14.[4] These rulings clarify some tax issues facing seniors and investors. Despite these rulings, however, important questions and uncertainties remain.

[1] Kevin Ring and Paul A. Siegert, *Taxation of Life Insurance Policies in an Evolving Secondary Marketplace* (Insurance Studies Institute, 2008).
[2] Letter from Herb Kohl (D-WI), United States Senator, to Timothy Geithner, Treasury Secretary (April 6, 2009) (on file at the TaxCore Treasury Documents). Senator Kohl's was not the first Congressional inquiry on this topic. In late 2007, Treasury sent a letter to Congressman Richard E. Neal (D, MA), noting that Treasury was aware of the pressing issue of addressing tax treatment of life settlement transactions and promising that guidance would be forthcoming.
[3] The Revenue Rulings were issued less than a month later, on May 1, 2009. Although the speed with which these issues were addressed was welcomed, the Rulings themselves were met with some reservation. Senator Herb Kohl, for example, stated, "I appreciate that the IRS provided guidance so quickly, however I believe that there may be additional clarifications made in order to make sure that those involved in life settlements are aware of these tax implications and are receiving proper direction at the time of the transaction."
[4] Revenue Rulings are not law in the same way that the Internal Revenue Code is law. Instead, Revenue Rulings are IRS pronouncements that apply to what the IRS perceives to be the law to a given set of facts. Revenue Rulings may be challenged by taxpayers in court, and on occasion, the Service will withdraw or revise Revenue Rulings. The proper level of judicial deference to Revenue Rulings is a matter of some controversy. *See*, *e.g.*, Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727 (2007). In some cases, a Code provision will expressly authorize Treasury to issue Revenue Rulings. In those instances, the regulations are given binding effect. *U.S. v. Bogel Fertilization Co.*, 455 U.S. 16 (1982).

The Life Settlement Industry

Traditionally, policy owners who wanted (or needed) to cease paying premium payments on life insurance policy had few options. They could simply stop paying the premiums and allow the policy to lapse, in which case they would receive nothing. Alternatively, the policy owners could surrender the policy to the insurance company. Surrender provides the policy owner with the cash value (also known as the surrender value) accumulated in the policy, as calculated by the insurance company.[5] Surrender allows the policy owner to receive some of the money that had been invested in the policy and provides the policy owner with some cash in hand.

The advent of the life settlement market brought a welcome third option to policy owners. Individuals can now readily sell unwanted policies into a competitive secondary market in exchange for the policy's fair market value.[6] Fair market value typically provides an amount to the policy owner that is materially greater than the surrender value.

This increase in value to the policy owner, however, is not without consequences, i.e., the surrender or sale of a life insurance policy is a taxable transaction to the policy owner. Similarly, when a purchaser of a life insurance policy resells the policy or receives the payout of a death benefit upon the death of the insured, the purchaser/re-seller experiences a taxable event.[7]

The life settlement industry is a burgeoning market. The market has grown from an estimated $2 billion in 2002 to an estimated $12 billion in 2007, and is predicted to grow at 11.5% annually over the next five years.[8] By 2017, the market is expected to reach $31 billion.[9] This predicted market growth, and the continuing uncertainty around the proper tax treatment of sales and surrenders, points to the need for guidance on the tax consequences of life settlement transactions. In a paper published last year, ISI posed a number of questions regarding the tax implications of a life settlement transaction.[10] Many of the questions posed by that article have been answered by Revenue Rulings 2009-13 and 2009-14.

This paper explores the tax implications of life settlement transactions in light of the newly released Revenue Rulings and provides an explanation of Revenue Rulings 2009-13 and 2009-14. This paper then undertakes an analysis of the potential impact of these Rulings on the life settlement industry, including an exploration of several problematic issues. It concludes with a

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[5] Surrender value is comprised of any premiums paid to the insurance company, less the "cost of insurance" for the premium period, plus any earnings on the account value. For example, if the monthly premiums were $500 and the cost of insurance for the insured (based on overhead, coverage, payments made to the insurer by others within the same policy class, etc.) in the same month was $350, the amount that would be contributed to the policy owner's surrender value would be $150 plus accrued earnings on the account value.

[6] Fair market value of a life insurance policy is based on many factors such as life expectancy of the insured, amount of account value in the policy, policy terms, etc. For an in-depth discussion of life settlement pricing, see Insurance Studies Institute, *Introduction To Methodologies Used To Price Life Insurance Policies In Life Settlement Transactions* (2008).

[7] In many circumstances, life insurance proceeds paid because of the death of the insured are not taxable. I.R.C. § 101(a)(1). Many exceptions to this general rule apply, however. If the policy has been transferred for valuable consideration, a portion of the proceeds are taxable. I.R.C. §§ 101(a)(2)-(g)(3).

[8] Corning Research & Consulting, Inc., *Life Settlements: New Challenges to Growth* (Hartford, Connecticut 2008).

[9] *Ibidem*

[10] Kevin Ring and Paul A. Siegert, *Taxation of Life Insurance Policies in an Evolving Secondary Marketplace* (Insurance Studies Institute, 2008).

summary of what remains unanswered and provides recommendations for moving toward greater clarity for policy owners, their advisors, and the life settlement industry.

Revenue Ruling 2009-13: Tax Implications To The Seller Of A Life Insurance Policy

Revenue Ruling 2009-13 begins by creating a common fact pattern that applies to each of three situations presented in the Ruling: on year 1, A (an individual) entered into a life insurance contract with cash value.[11] A is the current policy owner and the named beneficiary is a member of A's family. A, as policy owner, has the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The ruling states that the contract is a capital asset in A's hands.[12] Additionally, the facts provide that A has held the policy for 8 years, and that the surrender value for the contract is $78,000.[13] A has paid premiums totaling $64,000, and has neither received distributions under the contract, nor borrowed against the contract's surrender value. Lastly, A is not a terminally ill individual, nor a chronically ill individual, within the meaning of §101(g)(4).[14]

Situation 1: Surrender of a Life Insurance Policy with Cash Value: The Ruling first explains the tax consequences if A were to surrender the policy. The Ruling describes both the amount of income A would recognize, and the character of that income.

In Situation 1, A surrenders its policy back to the insurer for the policy surrender value. The IRS begins by noting that gross income includes all income from whatever source derived, including income from life insurance. Specifically, § 72(e) provides that amounts received under a life insurance contract on the "complete surrender, redemption or maturity" of the contract are included in gross income to the extent that the proceeds exceed the investment in the contract.[15] The "investment in the contract" is defined as "the aggregate amount of premiums or other consideration paid for the contract before such date, minus the aggregate amount received under the contract before such date."[16]

Relying on this straightforward combination of Code sections, the Service concludes that proceeds from the surrender of a life insurance contract are included in gross income to the extent the proceeds exceed the amount paid to the insurer for the policy. Applied to the fact situation in the ruling, since A received $78,000 on the surrender of the policy and had paid $64,000 in premiums

[11] A life insurance policy with cash value is considered a "universal" or "whole life" policy. A universal or whole life policy has both an insurance coverage component and an investment component. The investment component allows for cash build-up inside the policy itself. The build-up is attributable to amounts that has been paid in premiums that are in excess of the actual amount that the insurance company needs to receive in order to cover the insured's monthly insurance coverage costs, plus accrued earnings on the account balance. This coverage amount is considered to be the "cost of insurance." In contrast, in a term insurance policy the actual premiums paid to the insurance company are considered to be the cost of insurance, and thus no cash value or build-up is created, except that some consider the nominal annual policy fee to not be part of the cost of insurance.

[12] Property is treated as a capital asset provided it does not fall within a list of exceptions provided in I.R.C. § 1221. A life insurance policy contract does not fall within one of the exceptions, and the ruling states the non-controversial conclusion that in A's hands the contract is a capital asset. *See* I.R.C. § 1221; Rev. Rul. 2009-13, 2009-21 I.R.B. 1029.

[13] The Ruling explains the surrender value reflects the subtraction of $10,000 of "cost of insurance" charges.

[14] Special rules apply to the sale or surrender of life insurance policies by the terminally or chronically ill. *See* I.R.C. § 101(g)(4). These transactions are generally known as viatical settlements.

[15] I.R.C. § 72(e)(5)(A).

[16] I.R.C. § 72(e)(6).

(and had not received distributions), A's proceeds exceeded the investment in the contract by $14,000. This amount must be recognized and included in A's gross income.

The Service then turns to address the character of that gain. As the Revenue Ruling notes, § 72(e) does not specify whether income recognized upon surrender should be treated as ordinary income or as capital gain.[17] Subchapter P of the Code controls the outcome of that inquiry.[18] Section 1222 in Subchapter P defines a long-term capital gain as gain from the sale or exchange of a capital asset held for more than a year, if and to the extent such gain is taken into account in computing gross income.

Although a life insurance contract is a capital asset in the hands of the policy owner, the Service declares that the surrender of a life insurance contract does not produce a capital gain. For the conclusion that a surrender does not yield a capital gain the Service relies on Revenue Ruling 64-51, which holds that "the proceeds received by a *policy owner* upon the surrender of, or at the maturity of, a life insurance policy constitute ordinary income to the extent such proceeds exceed the cost of the policy."[19] Revenue Ruling 64-51 is supported by even older case law (not cited in the new Ruling), which holds that the surrender of a life insurance policy does not give rise to a sale or exchange of the policy itself.[20] The Ruling concludes this part of its analysis with this abrupt sentence: "Section 1234A, originally enacted in 1981, does not change this result." Section 1234A provides that "gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation…with respect to property which is a capital asset in the hands of the taxpayer…shall be treated as gain or loss from the sale of a capital asset."

Summary: Situation 1 instructs that whenever the owner of a universal life insurance policy surrenders a policy to the insurance company for the policy's surrender value, any amounts received in excess of the premiums paid for that policy will be included in gross income and taxed at ordinary rates. This is consistent with the conclusions presented in the 2008 ISI Taxation Paper.

Situation 2: Sale of A's Cash Value Policy: Surrender is not the only option available to A, however, and in Situation 2, the Service provides an explication of the tax consequences of the *sale* of a universal life insurance policy, rather than a surrender. Again, the Service addresses both the amount of the sale, and the character of any resulting gain. In Situation 2, A sells a policy to B for $80,000.[21]

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[17] Such a distinction is critical to taxpayers because capital gains are taxed at preferentially lower rates. In addition, capital *losses* can be taken only to the extent of capital gains (plus $3,000 for individual taxpayers). For that reason, taxpayers often need capital gains to offset or absorb their capital losses. In contrast, taxpayers generally prefer ordinary losses, since those losses are not limited in the same way as capital losses.

[18] Subchapter P includes I.R.C. §§ 1201-1260, regarding Capital Gains and Losses.

[19] Rev. Rul. 64-51, 1964-1 C.B. 322.

[20] Mark Leeds, *Providing Certainty on Death and Taxes: IRS Issues Initial Guidance for Sellers and Purchasers of Life Insurance Policies*, Vol. 99, No. 99 BNA Daily Tax Report (May 2009) (citing *Bodine v. Commissioner*, 103 F.2d 982; *Avery v. Commissioner*, 111 F.2d 19 (9th Cir. 1940)).

[21] B is unrelated to A, and would suffer no economic loss upon A's death. The Service adds these facts to make clear that B has no insurable interest in A's life. An "insurable interest" encompasses close familial relationships as well as those relationships with demonstrable economic dependencies, or those in a debtor-creditor relationship. Kelly J. Bozanic, *An Investment to Die For: From Life Insurance to Death Bonds, the Evolution and Legality of the Life Settlement Industry*, 113 PENN. ST. L. REV., 229 (2008-2009). When an individual obtains life insurance on him/herself, he/she can designate anyone as the beneficiary of his policy. *Clements v. Terrell*, 145 S.E. 78, 81 (Ga. 1928) (holding that an individual may designate as beneficiary an individual who has no insurable interest).

The Ruling begins by noting that gross income includes gains derived from dealings in property. Since it is not the gross proceeds, but only the gain that is taxed, the taxpayer's basis in the property is critical. Gain is determined by taking the amount realized, and subtracting adjusted basis. In Situation 2, A's amount realized from the sale is simply the sum received from B. A's adjusted basis is not so readily determined.

Typically, adjusted basis is simply the cost of the property adjusted for expenditures, receipts, losses, or other items chargeable to capital accounts.[22] The Ruling recognizes that a life insurance policy has both investment characteristics as well as insurance characteristics. Because of these dual characteristics, the Ruling reasons, the taxpayer's basis must be reduced by the amount of insurance protection utilized by the taxpayer during the period of time in which the policy was held.[23] To support this determination, the ruling cites a handful of cases[24] in which the IRS concludes that the amount paid in premiums under the contract should be reduced by the cost of insurance ("COI") portion of the policy to achieve basis.

Given this reasoning, in Situation 2, A's basis must be adjusted for the cost of insurance. A paid premiums totaling $64,000 through the date of the sale, and A's cost of insurance charges were given in the facts as $10,000. Accordingly, A's adjusted basis in the contract, as of the date of the sale, is $54,000 ($64,000 premiums paid, less $10,000 cost of insurance). Thus, A must recognize $26,000 on the sale of the life insurance contract to B for $80,000 (amount realized of $80,000 less adjusted basis of $54,000).[25]

Just as it did in Situation 1, the Ruling then turns to an explanation of the character of A's gain. Here, there is an actual sale of a capital asset rather than a surrender. Instead of simply treating the entire gain as capital, however, the Ruling adopts a bifurcated approach whereby some (or all) of the income will be characterized as ordinary if the "substitute for ordinary income" doctrine applies.[26] The Ruling reasons that under the substitute for ordinary income doctrine, "property" (within the meaning of §1221) does not include claims of right to ordinary income. Therefore, ordinary income that has been earned but not recognized cannot be converted into a capital gain

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[22] I.R.C. § 1016(a)(1). Recall that in Situation 1, basis was determined by reference to § 72. The Ruling notes that § 72 is not applicable to determine basis when the contract is sold because by its terms § 72 applies only to amounts received under the contract itself.

[23] This number is the cost of insurance (or COI). The COI is the actual amount that is incurred by the insurer to keep the policy in force during the period that policy owner holds the policy. This number is calculated by considering many variables such as the insurer's actuarial cost if death occurs within the year, commissions paid to agents, expenses to service the policy, overhead, etc.

[24] The Ruling cites *Century Wood Preserving Co. v. Comm'r*, 69 F.2d 967, 968 (3d Cir. 1934) (holding that cost is not the total amount paid in as premiums, since continuing insurance protection is part of the consideration for the contract, and noting that the part of the premiums which represents annual insurance protection has been earned and used); *London Shoe Co. v. Comm'r*, 80 F.2d 230, 233 (2d Cir. 1935) (noting, in the context of a situation where the policy was surrendered, not sold, that "the cost of the policy was approximately reflected in the cash surrender value, [and] . . . . [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) (holding that total premiums paid did not represent the cost of the life insurance contract because "to so hold would be to disregard the element of insurance protection in the period prior to the sale, the benefit of which accrued to the petitioner.").

[25] Compare this gain of $26,000 with the much lower gain of $14,000 when A surrendered its policy. This large taxable gain discrepancy is not consistent with the minimal differential amount received by A when the policy was surrendered ($78,000) and the amount for which the policy was sold ($80,000).

[26] The substitute for ordinary income doctrine "provides that when a party receives a lump sum payment as essentially a substitute for what would otherwise be received at a future time as ordinary income that lump sum payment is taxable as ordinary income as well." *Womack v. Comm'r*, 510 F.3d 1295, 1299 (11th Cir. 2007) (internal quotation omitted).

by a sale or exchange. The Ruling then notes that the substitute for ordinary income doctrine has been applied to characterize the profit on the sale of a life insurance contract as ordinary income.

Although some of the income A recognized will be treated as ordinary under the substitute for ordinary income doctrine, the Ruling concedes that upon a sale, the amount that must be treated as ordinary income is limited to the amount that would be recognized if the contract were surrendered. If the policy owner recognizes income in excess of the surrender value (i.e., in excess of the "inside build-up"), that excess qualifies as gain from the sale or exchange of a capital asset.

As applied to the facts in Situation 2, the inside build-up under A's life insurance contract before the sale is $14,000.[27] Thus, $14,000 will be recognized as ordinary gain. Because A must recognize a total gain of $26,000, the additional $12,000 of gain is treated as capital gain.

Summary: Situation 2 adopts a bifurcated approach to the gain realized on the sale of a life insurance contract. The process involves a multi-step calculation in which the policy owner first determines total gain and then allocates that gain either to inside build-up (which is ordinary gain) or appreciation (which is capital gain).

The steps are as follows: (1) Determine total gain by subtracting basis from amount realized. Basis is aggregate premiums paid, less cost of insurance. (2) Determine the amount of total gain that is ordinary by subtracting aggregate premiums paid from the contract's cash surrender value. (3) Total gain, less gain treated as ordinary, will yield the amount treated as a capital gain.

In other words, Situation 2 stands for the principle that when a policy owner sells a life insurance policy to a third party for valuable consideration, any amounts received that are in excess of the owner's basis in the policy (which has been reduced by cost of insurance) will be taxed. The difference between the surrender value and policy owner's original basis (not reduced for cost of insurance) will be ordinary income, and any excess recognized income will be taxed at capital gains rates (assuming adequate holding period).

Situation 3: Sale of a Term Policy: In Situation 3, A sells a fifteen-year term life insurance policy, which has no surrender value and a monthly premium of $500. A has made payments totaling $45,000 up to the date when the contract is sold to individual B for $20,000.[28] A sells the policy mid-month; A has already paid that month's premium of $500 and is receiving coverage at the time of the sale.

The amount realized from the sale of the contract, the Ruling notes, is the sum of money received from the sale, or $20,000. The Ruling provides that A's adjusted basis is equal to the total premiums paid under the contract, less charges for the provision of insurance before the sale. The Ruling specifies that absent other proof, the cost of insurance protection provided to A each month is presumed to equal the monthly premium under the contract, or $500.[29]

[27] This number is achieved by taking the $78,000 cash surrender value and subtracting the $64,000 of premiums paid.
[28] Again, B has no relationship to A and would suffer no economic loss upon A's death.
[29] In a term life insurance policy, there is no investment portion of the contract.

Thus, in Situation 3, the cost of insurance protection provided to A during the 89.5 months that A held the contract is $44,750.[30] Therefore, on the date of sale, A's adjusted basis in the contract was $250.[31] Accordingly, A must recognize $19,750 on the sale of the insurance contract to B.[32]

The Ruling then turns to the character of the gain and concludes that all of the gain qualifies as long-term capital gain. Because a term insurance policy has no surrender value, there is no inside build-up under the contract to which the "substitute for ordinary income" doctrine could apply. The policy in A's hands is considered a capital asset, and A held the asset for the requisite holding period; therefore, the Ruling concludes that the amount that A must recognize on the sale of the contract is long-term capital gain within the meaning of §1222(3).

<u>Summary</u>: Situation 3 provides that any gain recognized from the sale of a term life insurance policy held for the requisite period will be recognized as capital gain.

Revenue Ruling 2009-14: Tax Implications To The Buyer Of A Life Insurance Policy

Revenue Ruling 2009-14 begins by presenting a common fact pattern (similar to that of 2009-13, Situation 3 above) to be applied to each situation of this ruling: A is a United States citizen, residing in the United States.[33] B is also a United States taxpayer[34] who uses the cash method of accounting and files income returns on a calendar year basis. B purchases a term life insurance contract[35] without a cash surrender value from A for $20,000. The contract was originally issued to A by an insurance company. The purchased policy has premiums of $500 per month and has a remaining term of 7 years, 6 months, and 15 days. B has no insurable interest in A's life, and except for the purchase of the contract, B has no relationship to A and would suffer no economic loss upon A's death. B purchased the contract with a view to profit. In B's hands, the contract is a capital asset.

Situation 1: Tax Impact for a Purchaser Upon the Receipt of a Death Benefit: The Ruling provides that after B purchased the policy from A, but before A's death, B paid $9,000 in premiums. On A's death, B received $100,000 under the life insurance contract by reason of A's death.

Gross income generally does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured.[36] However, if the policy has been

[30] $500 monthly premiums multiplied by 89.5 months of coverage equals $44,750.
[31] $45,000 in premiums paid, minus $44,750 for cost of insurance ("protection used"), results in an adjusted basis in the contract of $250.
[32] This number accounts for the $20,000 amount realized, minus the $250 adjusted basis in the contract, to result in the $19,750 gain recognized on the sale.
[33] These facts determine that A is subject to the laws regarding domestic persons as they relate to the taxability and payment of income.
[34] B is a person as defined in § 7701(a)(30) and is subject to the laws regarding domestic persons as they relate to taxability and payment of income.
[35] Revenue Ruling 2009-14 does not address the tax implications for a buyer of a universal life insurance policy having an account value. This limitation may not be an issue for the industry, as secondary market purchasers generally strip out the account values of universal life policies through withdrawal, application to future premiums, or borrowings. Mark Leeds, *Providing Certainty on Death and Taxes: IRS Issues Initial Guidance for Sellers and Purchasers of Life Insurance Policies*, Vol. 99, No. 99 BNA Daily Tax Report (May 2009).
[36] I.R.C. § 101(a)(1).

transferred for valuable consideration, the exclusion from income does not apply with full force. Instead, according to § 101(a)(2), the exclusion is limited to the amount equal to the total of the actual value of consideration paid plus the premiums and other amounts subsequently paid by the transferee.

Because B purchased the contract from A for $20,000, B's acquisition constitutes a "transfer of valuable consideration" under § 101(a)(2). Thus, B may reduce the $100,000 taxable death benefit income by the value of the consideration B paid to A for the contract, plus the total of premiums and other costs B paid to maintain the policy. B may reduce the $100,000 taxable death benefit by $29,000[37] and must recognize the remaining $71,000[38] as gross income.

The Ruling then addresses the character of the income, and begins by noting that §72(e) does not specify whether death benefits should be treated as ordinary income or as capital gain. Again, Subchapter P controls the character of gain recognized on this transaction. A life insurance contract is a capital asset, and B has held it for the requisite statutory period. The Ruling, nonetheless, states that the receipt of a death benefit from the issuer under the terms of the contract does not produce a capital gain.[39] Accordingly, the ruling holds that the $71,000 recognized by B on the receipt of death benefits from A's death under the contract is ordinary income.

Summary: If a buyer purchases a term life insurance policy from the policy owner or another third party, and holds it to maturity, any amounts that are received from the death benefit in excess of the value of the buyer's consideration and subsequent amounts paid to maintain and service the policy will be includable in gross income and will be taxed at ordinary gains rates.

Situation 2: Resale of a Previously Purchased Life Insurance Policy: In Situation 2, rather than holding the policy until A's death, B sells it to C (an unrelated person) for $30,000. To calculate B's gain, B's basis in the policy must be determined.[40] The Ruling states that the analysis for determining basis begins with initial cost.[41] Taxpayers add to that initial cost any subsequent amounts paid to create or enhance a future benefit for which capitalization is appropriate. The premiums and servicing costs paid by a secondary market purchaser of a term life insurance contract do just that—create or enhance a future benefit for which capitalization is appropriate.[42]

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[37] This amount includes the $20,000 paid to A and the $9,000 paid in premiums.

[38] This amount is the $100,000 realized upon the receipt of the death benefit, reduced by the $29,000 paid by the transferee to acquire and continue the force of the policy. It constitutes the amount realized upon the transaction.

[39] The Ruling is silent as to why a death benefit in the hands of a buyer-investor does not constitute a capital gain. The Service implicitly takes the position that the receipt of a death benefit does not constitute a "sale or exchange" of a capital asset. The Service also implicitly rejects the application of § 1234A, a rejection which was explicit, yet insufficiently supported, in Revenue Ruling 2009-13.

[40] The Ruling states that § 101(a)(2) is not applicable to determine basis in the contract when it is sold because § 101 only applies to amounts received by reason of death of the insured.

[41] Any amount paid to another party to acquire an intangible asset in a purchase transaction is included in basis. Treas. Reg. § 1.263(a)-4(c)(1)(iv). A life insurance contract is considered an intangible asset.

[42] The Ruling cites Treas. Reg. § 1.263(a)-4(b)(1)(iv), which authorizes the Service and Treasury to publish guidance in the Internal Revenue Bulletin that identifies a future benefit as an intangible for which capitalization is required. The Ruling then specifies that premiums paid by the purchaser of a term life insurance contract enhance such a future benefit and thus require capitalization for such payments. Servicing costs are also likely to be permitted to be added to basis. *See* 33A Am. Jur. 2d ¶ 12806 (updated May 2009) (noting that premiums paid and "other amounts" are permitted to be added to basis, and commenting that "other amounts" include costs that are not allowed as a deduction by reason of Code Sec. 264(a)(4)). Servicing costs include trustee/custodial fees, insured tracking fees, reporting expenses, document

Thus, the $9,000 in premiums paid by B to keep the policy in force must be added to B's adjusted basis. This brings B's total adjusted basis in the term life insurance contract to $29,000.

Next, the ruling describes the facts of Situation 2 presented by Rev. Rul. 2009-13 and discusses how the current situation is distinguishable in regard to the impact of "cost of insurance" on basis. In Ruling 2009-13, the seller (the original policy owner) was required to reduce its basis by the cost of insurance. In Ruling 2009-14, the seller is not the original policy owner, and there is no reduction for cost of insurance charges. The Ruling reasons that because B is wholly unrelated to A and did not purchase the life insurance contract for protection from any economic loss upon A's death, no reduction for COI is necessary.[43] B simply acquired and held the contract solely with a view to profit, and continued the payments on the policy to prevent the investment from lapsing. Therefore, in Situation 2 of Ruling 2009-14, the amount realized on B's sale to C was $30,000, B's adjusted basis was $29,000[44], and thus B must recognize $1,000[45] on the sale of the life insurance contract to buyer C.

The Ruling discusses the character of B's gain, and provides that because the policy in the hands of B was a capital asset and was held for more than one year, the $1,000 gain recognized by B on the sale of the term life insurance policy to C is a long-term capital gain. The substitute for ordinary income doctrine does not apply, the ruling notes, because the contract was a term contract with no cash value.

Summary: When a buyer purchases a life insurance contract from the policy owner (or a subsequent purchaser) and then resells it to another purchaser, any gain that the buyer realizes in excess of the initial consideration paid plus any subsequent premium payments and other costs will be taxed as capital gains.

Situation 3: Taxation on Receipt of Death Benefits by a Foreign Purchaser: In Situation 3, the Ruling returns to the facts presented in Situation 1 of 2009-14, but changes the identity of B, the purchaser, to a foreign party. Policy owner A sells a policy to B, where B is a foreign corporation that is not engaged in a trade or business within the United States.[46]

The ruling provides that B must recognize $71,000 of income upon the receipt of death benefits of $100,000 paid by the insurance company resulting from A's death.[47] The Ruling then determines that §881[48] applies to B because B is a foreign business not connected with United States business

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expenses, updating of medical records and life expectancy of the insured, obtaining death certificates, and collection of death benefits. Such servicing costs can range from $300 to $2000 per year per policy over the remaining life of a policy.

[43] In making this determination, the Ruling cites Rev. Rul. 2009-13; *Century Wood Preserving Co. v. Comm'r*, 69 F.2d 967 (3d Cir. 1934); *London Shoe Co. v. Comm'r*, 80 F.2d 230 (2d Cir. 1935); and *Keystone Consol. Publ'g Co. v. Comm'r*, 26 B.T.A. 1210 (1932) to distinguish the situations. In these cases, the adjusted basis was reduced for cost of insurance charges because the charges represented the cost of insurance protection that was enjoyed by the policyholder as the beneficiary of the policy. However, since B is not enjoying any benefits of protection, B is not required to include any "usage" charges.

[44] This number accounts for the $20,000 purchase price that B paid to A for the initial acquisition of the contract plus the $9,000 cost of the additional premiums that were paid by B to prevent the policy from lapsing.

[45] This number represents the $30,000 amount realized on the sale to C less B's $29,000 adjusted basis in the contract, which results in the $1,000 amount recognized by B on the sale of the contract to C.

[46] The ruling specifies that B is not involved in the trade or business of purchasing or taking assignments of life insurance contracts.

[47] This amount is based on the same calculations made in Situation 1.

[48] §881 governs the tax on income of foreign corporations not connected with United States business.

and is thus subject to a different tax rule than those considered to be a United States entity. The Ruling goes on to reason that the death benefit is "fixed or determinable annual or periodical" income within the meaning of § 881,[49] and consequently, B is subject to taxes imposed under this rule if the income is from sources within the United States.

The source of the income is then addressed in order to determine whether the income is from United States sources, and is thus taxable under this rule. Typically, no hard and fast rules dictate the "source" of income, but occasionally the source of a particular item of income will be specified by a statute or regulation. When no statute or regulation applies, courts determine source of income by comparison and analogy to classes of income specified within the statute. For example, the Ruling states that interest received from a domestic corporation is generally from sources within the United States.[50] It then adds that when life insurance contracts are issued on lives of United States residents, premiums received are generally considered income from sources within the United States as opposed to foreign income.[51] The Ruling also provides that the source of income from the sale of personal property is generally determined by reference to the residence of the taxpayer.[52] This means that income from a sale of personal property by a United States resident will have income sourced in the United States, and income from a nonresident will have income from sources outside the United States.

The Code does not specify the source of income received from the payment of a death benefit under a life insurance contract, so the source of income must be determined by comparison and analogy.[53] The Ruling specifies that in Situation 3, because the insured (A) is a United States citizen residing in the United States and the insurance company is a domestic corporation, the income (death benefit) must be from sources within the United States. Thus, B must recognize $71,000[54] of ordinary income from sources within the United States, which will be taxed under § 881(a)(1).[55]

Summary: When a purchaser of a life insurance contract is a foreign entity that does not conduct trade or business within the United States, any income recognized from the receipt of a death benefit (amounts recognized will be those amounts in excess of the value of the buyer's consideration and subsequent amounts paid to maintain and service the policy) will constitute ordinary income and will be taxed in accordance with §881 of the code when the income is from sources within the United States.

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[49] In making this determination, the Ruling cites §1.1441-2(b); Rev. Rul. 64-51, 1964-1 C.B. 322 and Rev. Rul. 2004-75, 2004-1 C.B. 516.
[50] I.R.C. § 861(a)(1).
[51] I.R.C. § 861(a)(7).
[52] I.R.C. § 865.
[53] Courts have routinely determined the source of the item by comparison and analogy to classes of income specified within the Code. The Ruling cites *Bank of America v. United States*, 680 F.2d 142, 147 (Ct. Cl. 1982); *Howkins v. Commissioner*, 49 T.C. 689 (1968); *Clayton v. United States*, 33 Fed. Cl. 628 (1995), *aff'd without published opinion*, 91 F.3d 170 (Fed. Cir. 1996), cert. denied, 519 U.S. 1040 (1996); Rev. Rul. 79-388, 1979-2 C.B. 270.
[54] This recognized amount results from the $100,000 amount realized on the receipt of the death benefit of A, reduced by B's $29,000 adjusted basis in the policy.
[55] I.R.C. § 881(a)(1) (providing that "there is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a foreign corporation . . . .").

Analysis: Some Certainty, Some Ambiguity

The Revenue Rulings were requested and the clarifications welcomed. They were met with enthusiasm from some observers. Although the Rulings provided some much needed guidance, they did not, however, answer all outstanding questions. Furthermore, in the process of providing guidance, the Rulings created some confounding discrepancies, which are explored below.

Surrender vs. Sale: An Unjustified Distinction?

In regard to the original policy owner, the Rulings treat surrender in a far more tax-advantageous way than a sale. This disparity is not adequately explained by the Rulings,[56] and results in unjustified distortion and unintended consequences for seniors and the life settlement industry.

The Disparity: To illustrate the disparity, recall that in Situation 1 of Rev. Ruling 2009-13, the policy owner surrenders a policy for the cash surrender value of $78,000. In that situation, the policy owner has $14,000 of ordinary income. In Situation 2, the policy owner sells that same policy for $80,000; a mere $2,000 more. The policy owner's income, however, does not go up by the additional $2,000. Instead, the Service calculates that owner's income jumps by an astounding $12,000, from $14,000 in Situation 1, to $26,000 in Situation 2. It is true that some of the $26,000 will qualify for capital gains treatment. However, the fact that a portion of that excess income is capital gain income is likely little solace for the policy owner, who must now pay tax on nearly twice as much income.

This differing treatment between sale and surrender results from the Revenue Ruling's treatment of basis. In the surrender situation, basis is guided by § 72,[57] which provides that basis is the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount received under the contract. This amount is subtracted from the cash surrender value to arrive at the total amount the policy owner must recognize as income.[58]

In contrast, in the case of a sale, the Revenue Ruling refers not to § 72, but to the more general basis rules. The significant difference is that the Revenue Ruling requires policy owners to "back-out" or subtract the COI from the aggregate premiums paid to arrive at basis. The Ruling requires that when the original policy owner sells a policy, the policy owner must subtract the COI from the total premiums paid to arrive at total gain (also referred to as amount realized).

The differing treatment of COI when assessing the character of the income is not the only disparity involving COI. The Ruling depends on the surrender value of the policy to provide a numerical value of the inside build-up of the policy. Surrender value, however, has already accounted for

[56] Although the Revenue Ruling cites cases in support of its basis treatment, the Ruling's analysis remains unpersuasive. Specifically, the cases involve taxpayers claiming losses and corporate-owned life insurance policies on employees, and all predate the 1954 Internal Revenue Code. *See* Letter from Kirk Van Brunt & Roger D. Lorence to Doug Head, Executive Director, Life Insurance Settlement Association (May 2009) (on file with the Insurance Studies Institute making this same observation).

[57] I.R.C. § 72 does not use the term "basis" but refers to the *policy owner's* "investment in the contract."

[58] Surrender value is the equity built up in a policy when the premiums paid exceed the actual cost of insurance. Because surrender value already accounts for COI, an policy owner should not be, and is not, required to account for this COI when determining the amount or character of taxable income.

the COI. Because the Ruling uses the surrender value as a benchmark for the value of the policy, the value of the policy already accounts for the cost of insurance. Since the policy owner is required to deduct the COI from that "benchmark," the policy owner's COI is effectively counted twice. This method of calculating taxable income, in essence, requires the cost of insurance to be backed out twice, and permits the IRS to "double dip."

The impact of the double dip is illustrated in Table 1 below. This table shows the amount by which the sale price of a life settlement must exceed the surrender value for the policy seller to realize the same net proceeds after pay the increased tax caused by the cost of insurance being subtracted from the policy tax basis.

Table 1

The Amount of a Life Insurance Policy Sale (Life Settlement) Required to Equal the After Tax Proceeds if the Policy Were Surrendered

	What If Hypothetical Cases			
	Case 1	Case 2	Case 3	Case 4
eath Benefit	$500,00	$500,00	$500,00	$500,00
otal Premiums Paid Since Policy Purchase	$22,48	$35,00	$22,48	$35,00
otal Cost of Insurance Charged by Insurer Since Policy Purchase	$12,64	$11,00	$12,64	$11,00
efore Tax Amount to be Received Upon Surrender	$15,48	$45,00	$15,48	$45,00
Ordinary Income Tax Rate	**33**	**33**	**45**	**45**
Capital Gain Tax Rate	**15**	**15**	**20**	**20**
fter Tax Cash With Policy Surrender:				
urrender Value	$15,48	$45,00	$15,48	$45,00
ax Basis = Total Premiums Paid	$22,48	$35,00	$22,48	$35,00
Ordinary Income = Surrender Value Less Premiums Paid, but not Less Than "0"	Non	$10,00	Non	$10,00
Capital Gain = None	Non	Non	Non	Non
ax Expense	Non	$3,30	Non	$4,50
fter Tax Proceeds With Surrender	**$15,48**	**$41,70**	**$15,48**	**$40,50**
ife Settlement Sale Amount Required to Equal After Tax Surrender:				
ax Basis = Total Premiums Less Total COI	9,83	24,00	9,83	24,00
Taxable Ordinary Income = Surrender Value Less Tax Basis (not < 0)	5,65	21,00	5,65	21,00
Taxable Capital Gain = Sale Price Less Ordinary Income (not < 0)	13,76	32,50	15,47	36,18
ax Expense (Ordinary Tax + Capital Gain Tax)	3,93	11,80	5,63	16,68
ale Proceeds Needed to Equal After-Tax Surrender Proceeds	**$19,42**	**$53,50**	**$21,12**	**$57,18**
mount By Which Sale Proceeds Must Exceed Surrender Amount	**$3,93**	**$11,80**	**$5,63**	**$16,68**
By Which Sale Proceeds Must Exceed Surrender Amount	**125**	**119**	**136**	**127**

(This table created by Christopher Kampa, Director of Research and Project Development at Insurance Studies Institute.)

An Alternative Approach: In our view, this treatment reflects a misunderstanding of the economics of the transaction. Specifically, when a contract has a surrender value of $78,000, and the policy owner sells the contract for $80,000, the surrender value (and any built up cash accumulation) has already been calculated into the transaction. The senior is receiving the cash surrender value of $78,000 plus boot of $2,000. To be sure, the senior should be taxed on that additional $2,000, but morphing that $2,000 into an additional $12,000, as the ruling does, simply does not make sense on either an economic or a policy level.

An alternative approach would eliminate the odd preference for surrender, and would more realistically reflect the economics of the transaction. We suggest the following two-step approach to determine the gain resulting from the sale of a policy by the original policy owner: First, ordinary income is determined just as it is in a surrender situation, i.e., the policy owner subtracts premiums paid from cash surrender value. Second, the policy owner subtracts the net cash surrender value from sale amount realized to arrive at the amount of gain that is treated as capital gain (this is the "boot").

This alternative approach accounts for cost of insurance (since surrender value takes into account that cost). It also offers at least two benefits. First, it eliminates the inexplicable preference for surrender because it does not artificially inflate the policy owner's realized income. Second, this approach does not require the policy owner to know the COI – a number that might not be readily available. Instead, the approach uses a more accessible number – the cash surrender value – as a proxy for COI.[59]

Consequences to Policy Owners and the Life Settlement Industry: Policy owners weighing their options of sale versus surrender will be forced to consider the significant tax consequences. Given the respective tax treatments, some life insurance policies that would have been sold will instead be surrendered. Only when the sale price is sufficiently greater than the surrender value to compensate for the added tax burden will a rational policy owner choose sale over surrender. In other words, policy owners will be forced to demand higher prices for sale to achieve equal after-tax cash. This tax-driven demand could lead to the policy being passed over by the investor. Even when the sale price is sufficient to entice a sale, policy owners will end up with a significant tax burden and ultimately less cash in hand. These odd incentives almost certainly will deter some from participating in life settlement transactions—a result which could lead to slower than expected growth in the life settlement market.

Inconsistent Basis Treatment: The Service is working hard to treat life insurance as a dual-use asset. It is trying to capture the accretion portion of a policy as ordinary income, while simultaneously disallowing the "personal use" part (in other words, the cost of insurance component) to be morphed into the investment component.

[59] Courts and the Service have used surrender value as a means to estimate cost of insurance. *E.g.*, *Century Wood*, 69 F.2d at 968 ("cash surrender value" is "roughly, the return of the equivalent of his investment after the cost of annual protection is deducted from the premiums"); I.R.S. Chief Couns. Advisory 2005-04001 (Oct. 12, 2004). ("[S]urrender value is the amount of premiums reduced by the sum of the cost of the insurance protection.").

Under the new Rulings, the tax treatment to original policy owners for a sale transaction is not consistent with other assets that individuals hold for dual purposes. Many taxpayers hold their principle residences, for example, for dual purposes. Most homeowners need a place to live, but also own homes because homes traditionally appreciate in value. When homes are sold, taxpayers have never been asked to "back out" from their basis the amount of benefit the homeowner received from living in the home.[60]

The treatment is also inconsistent with previously published guidance by the Service, which had adopted the approach in 72(e), which does not require the cost of insurance to be deducted from basis.[61] The Service alters its approach in the current Revenue Rulings by requiring cost of insurance to be deducted from basis in some circumstances, but the Service's previous guidance has yet to be withdrawn. The Ruling implements a significant change in basis calculation, and given the Service's previous guidance, the change undermines taxpayers' legitimate interest in relying on the past guidance. Taxpayers have made decisions regarding their life insurance policies with the understanding that the previously published guidance would apply to the disposition of those policies. Now, taxpayers are forced to take into account a significant change in how the basis of their policies will be calculated upon a sale. Absent adequate justification, such a significant change risks undermining taxpayers' confidence in the IRS.

Another inconsistency created by the Rulings is that only the original policy owners, not subsequent investor-purchasers, are required to back-out cost of insurance. Revenue Ruling 2009-14 specifies that any third-party investor who purchases a policy and later re-sells that policy is not required to account for any COI calculations. In this way, original policy owners are treated less favorably on the sale of policies than secondary purchasers.[62]

No Congressional Policy Justification Offered: The differing tax treatment evidences a clear preference for surrender, as opposed to sale. Given this counterintuitive preference, and considering the disparities and potentially serious unintended consequences, a strong policy justification would be expected. Unfortunately, there is no indication as to why this differing treatment was the method adopted by the Rulings. Indeed, Revenue Rulings are not the proper

[60] This hypothetical bifurcated approach could require taxpayers to subtract from basis the fair rental value of their home during the period of occupancy. We concede that this analogy is not perfect, because most taxpayers selling principle residences do not have to report income at all. *See* I.R.C. § 121 (permanently excluding from income up to $500,000 of gain on the sale of a residence provided certain residency requirements are met). However, the exclusion from income for gain recognized on the sale of a primary residence is a recent development (1997), and prior to the exclusion, the Service did not require a bifurcated approach. *See also* Letter from Kirk Van Brunt & Roger D. Lorence to Doug Head, Executive Director, Life Insurance Settlement Association (May 2009) (on file with Insurance Studies Institute) (criticizing the requirement that cost of insurance be backed out of basis is not adjusted for consumption or exhaustion for other personal assets such as houses or cars).

[61] Kevin Ring and Paul A. Siegert, *Taxation of Life Insurance Policies in an Evolving Secondary Marketplace*, pp. 9-10 (Insurance Studies Institute, 2008) (citing *Phillips v. Comm'r*, 275 F.2d 33 (4th Cir. 1960); Rev. Ruling 70-38, 1970-1 C.B. 11). The 2008 ISI Taxation paper noted the possibility that the Service might change its approach to calculating basis. *See id.* at p. 10 (noting "after initially adhering to this formula, the IRS has begun to argue . . . that the proper tax basis calculation for life insurance policy sales should not include the portion of the premium attributable to the cost of insurance…the written determinations…should be noted as they may signal a future tax policy shift that could have a substantial effect on the life settlement industry and seniors considering life settlements and/or obtaining premium finance loans.")

[62] The New York State Bar Association, in a lengthy report, recommended that there be no reduction for cost of insurance for subsequent purchases for value. John T. Lutz, *Report on Investor-Owned Life Insurance*, 2008 N.Y. ST. B.A. Tax Section, pp. 18-21. The report's main argument in its basis discussion was that a subsequent investor may include in its basis the aggregate premiums paid after it originally acquired the policy. *Ibid.* at 18 (noting that "the critical question is whether [a secondary market purchasers'] basis in the contract will increase by the amount of premiums paid under the policy post acquisition.").

venue for making such tax policy judgments. Congress, not the Treasury, is the governing body that sets tax policy.[63] If Congress wants to discourage sales of life insurance contracts, it should do so only after considered debate, and with the benefit of input from all interested constituencies.

Congress has, in fact, held hearings regarding the life settlement industry. In its latest investigation into the impact of the life settlement industry on seniors, the Senate Special Committee on Aging made no findings that seniors should be discouraged from selling their policies.[64] Instead, the Committee's findings noted that life settlements can be "a valuable way for seniors to derive previously inaccessible economic value from their life insurance policies."[65] The Committee did, however, express concern about the lack of guidance on the proper tax treatment for surrenders and sales. In that discussion there was absolutely no indication that seniors should suffer more severe tax consequences when they sell their policies as opposed to surrendering those policies. In addition to this recently expressed concern for seniors and the policy owners, Congress has historically shown a strong interest in encouraging citizens to purchase insurance.[66] The general rule that death benefits are excluded from income is evidence of that Congressional interest.

Cost of Insurance

A related difficulty that we observed is the Ruling's reliance on the cost of insurance. COI is not a static number, but changes from pay period to pay period. COI accounts for many variables including, among others, overhead, supervision of the policies, return on investment, mortality costs, and changes in policy administration. Because of the large variety of factors that make up the COI numbers, this number is very difficult to predict, especially on a long-term basis.

Cost of insurance can, however be calculated by the insurance companies at the end of each pay period. In fact, paying only the COI every pay period is how many life settlement investors continue to keep their investments in force. The investors contact the insurance carriers and request that their COI for the pay period be calculated, and the investors then pay that base amount. To remove any cash value accumulations of the policy built up by the previous policy owners, the investors often use the built-up amounts to pay the COI, thereby stripping the policy of any investment characteristic.

If cost of insurance is to be instrumental in calculating the gains received from a sale, these numbers must be readily accessible by the policy owner. This raises a host of other issues such as whether the insurance companies will be forced to keep strict records of these amounts for each policy owner; whether this number is knowable for policies that are already in force; whether

[63] John F. Coverdale, *Chevron's Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings after Mead*, 55 ADMIN. L. REV. 39, 72 (2003) (noting that Revenue Rulings "represent the IRS's interpretation of the law, but are not exercises in policymaking.").
[64] *See* Maj. Staff of S. Special Comm. on Aging, 111TH Cong., Report on Comm. Investigation of Life Settlements: Risks to Seniors (April 29, 2009).
[65] *Ibid.* at 2. To be sure, the findings expressed concerns about the adequacy of information seniors received. For example, the Committee worried that seniors might not be aware that the sale of a life insurance policy could result in the inability to obtain more life insurance. *Ibid.* at 5.
[66] Mitchell M. Gans & Jay A Soled, *A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference*, 7 FLA. TAX REV. 569, 605 (2006) (collecting tax-based evidence of Congressional pro-insurance position).

these numbers will be required to be disclosed to the policy owner every pay period; whether estimates of these numbers should be disclosed to the policy owner before they agree to be a policy holder; and if the insurance company and the policy owner can rely on those estimates, what degree of error in the estimates is tolerable? If the insurance companies are required to estimate the COI retroactively on previously issued policies, how dependable will those estimates be; how much transparency will the insurers provide; is there potential to artificially inflate the COI; who will hold the insurers accountable; what ramifications will result from such estimates?

Application of 1234A

Section 1234A provides that "gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation…with respect to property which is a capital asset in the hands of the taxpayer…shall be treated as gain or loss from the sale of a capital asset." Because life insurance policies are doubtless capital assets, there is an argument that 1234A applies when a policy owner surrenders a policy, or when an investor receives a death benefit. The surrender of a policy arguably results in a "termination" of certain rights, just as the death of the insured results in the extinguishment of the contract. Despite this argument, and with no analysis whatsoever, Ruling 2009-13 concludes that §1234A does not apply to the surrender of life insurance policies. Similarly, in Situation 2 of Ruling 2009-14, the Ruling treats a death benefit received by the buyer-investor as ordinary income. In so doing, the Service implicitly takes the position that the receipt of a death benefit does not constitute a "sale or exchange" of a capital asset, and also implicitly rejects the application of §1234A.

The conclusion that 1234A does not apply to surrenders or to death benefits results in less favorable tax treatment for sellers and investors. Specifically, if 1234A were to apply, the surrender or death benefit would almost certainly result in capital gain treatment. Given the significant tax consequences, it is curious that the Service did not provide even a cursory rationale for the inapplicability of § 1234A.[67]

This inapplicability is not without consequences for investors. In particular, the treatment of sale proceeds as capital (to investors) but death benefits as ordinary income provides an incentive for investors to get rid of policies prior to the receipt of death benefits. It could also lead to "basis boosting"—the practice of exchanging pools of policies for tax, rather than economic, reasons. Similarly, a potential unintended consequence of the Service's 1234A treatment is that policies might be subject to "flipping." Investors will note that holding the policy until maturity will yield ordinary income. In contrast, if the investor can sell prior to maturity, the investor will generate capital gain income. It's true that the investor will incur the tax liability earlier, but in some cases the favored capital gains will provide a sufficient incentive to sell the policy prematurely. This strong incentive against holding the policy upon death of the insured could render a policy a virtual "hot potato" for investors.

[67] This omission is even more notable because the New York State Bar Association's Report on Investor-Owned Life Insurance provided an analysis of this very issue. *See* John T. Lutz, *Report on Investor-Owned Life Insurance*, 2008 N.Y. ST. B.A. Tax Section, at pp. 7-10 (concluding that § 1234A should not apply to surrenders because income on surrender has historically been treated by the courts as ordinary, and there is no evidence that Congress intended that result to change with the enactment of 1234A).

Further, from a public policy standpoint, frequent turnover of policies could compromise the personal privacy of the insured. As the strength of each investment depends on the health and life expectancy of the insured, potential buyers inspect the medical records of the insured. Few of us are comfortable having our personal information and medical records seen by any third party. This concern becomes even more pressing for transactions in which the insured has no control or influence; once the policy is sold, they cannot monitor those who have access to their personal records.

30% Withholding Tax

Situation 3 of Revenue Ruling 2009-14 presents the tax consequences for a foreign investor on the receipt of a death benefit. The ruling declares, based on § 881(a)(1), that a withholding tax of 30% is due on the gain of a foreign investor when they are paid a death benefit.

This rule raises a significant practical challenge, i.e., the ruling is silent as to how the withholding agent (the insurance company) is to gauge the amount to withhold.[68] This is troublesome because failure to withhold the correct amount from the payment results in personal liability for any amounts outstanding. This potential liability will likely lead every withholding agent to withhold 30% of the entire death benefit to ensure tax compliance and protection from liability. This protective policy will make foreign investors hesitant to participate in the United States life settlement market, which in turn reduces the demand for policies and reduces the ability of seniors to sell their policies.

This issue's resolution would be improved with the adoption of the increased disclosure requirements. For example, as discussed below in the section on Obama's Greenbook, a method could be devised whereby a life settlement investor could report their basis to the insurance company at the time the death benefit claim was filed. The increased disclosure requirements could serve as a protective shield for the withholding agents and would better protect the investment of the foreign entity by allowing the investor to receive the entire amount that they are entitled to receive under the policy.

Limitation of Revenue Rulings

Revenue Rulings are not law; they are the IRS's interpretation or explanation of tax law or Treasury regulations—usually as applied to a hypothetical fact pattern.[69] Because Revenue

[68] *See* Letter from Kirk Van Brunt & Roger D. Lorence to Doug Head, Executive Director, Life Insurance Settlement Association (May 2009) (on file with Insurance Studies Institute) (making this observation).

[69] Treas. Reg. 601.201(a)(6) (explicitly noting that revenue rulings "do not have the force and effect of Treasury Department Regulations (including Treasury Decisions)."). *See also* Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance, and Retroactivity in the 21st Century: A View from Within*, 46 DUQ. L. REV. 323, 331-32 (discussing Revenue Rulings, and noting that Revenue Rulings are not "junior regulations").

Rulings are not law, they are more susceptible to legal challenge than, for example, Treasury regulations.[70]

A significant disadvantage of Revenue Rulings is that they are considered interpretative, and thus are not subject to the Administrative Procedures Act rulemaking requirements.[71] As such, Revenue Rulings are routinely issued without formal input from the public or interested parties. In this case, at least one interested and respected party, the Tax Section of the New York State Bar Association, provided thoughtful commentary to the Service. Such unsystematic and unsolicited commentary, however, should not take the place of a concerted effort to obtain the collected opinions and input of all stakeholders.

Obama's Greenbook

Although not part of the Rulings, the recent release of President Obama's General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals (the "Greenbook") foreshadowed some changes that could bind the life settlement industry in the coming years.[72] These changes include increased reporting requirements that are expected to bring formality to disclosure in life settlement transactions.

The Greenbook would require purchasers of life insurance policies with death benefits exceeding $1 million or more to make certain disclosures. Specifically, purchasers would be required to provide the purchase price, the buyer's and seller's tax identification numbers, the policy issuer, and the policy number to the IRS, the insurer, and the seller.[73] In addition, the Greenbook also requires the insurer to make specific disclosures to the IRS when a death benefit is made to secondary market purchasers. The insurers will be required to report the total gross benefit payment, the buyer's tax identification number, and an estimate of the basis of the policy.[74]

ISI expects that these disclosure requirements will lead to more accurate reporting on behalf of taxpayers. One foreseeable complication, however, is that insurers will be required to make an estimate of the purchaser's basis—an estimate that insurance companies are often in no position to make. Estimations of this important number are in no way a substitute for the specifics required for the taxpayer.

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[70] *See also* Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727, 1798 (2007) (noting that IRS attorneys "prefer temporary regulations to less formal guidance formats like revenue rulings and notices because the latter are nonbinding and receive less deference from the courts.").

[71] Dale F. Rubin, *Private Letter and Revenue Rulings: Remedy or Ruse?* 28 N. KY. L. REV. 50, 52 (2000) ("Revenue rulings are considered interpretive rules for purposes of the Administrative Procedure Act (APA), and are exempt from notice and comment issuance procedures and are published without a precedent announcement.") (internal citation omitted). *See also* John F. Coverdale, *Chevron's Reduced Domain: Judicial Review of Treasury Regulations and Revenue Rulings after Mead*, 55 ADMIN. L. REV. 39, 72 (2003) (presuming that the APA does not apply to Revenue Rulings by noting, "[t]he deference owed to revenue rulings is not as great as that owed to general authority regulations because they have not been subject to notice and comment which makes special deference appropriate since it gives regulated parties an opportunity to participate in the formulation of the rule.").

[72] The proposals are bound with a green cover, and hence are called the "Greenbook." The Greenbook contains over 100 pages of explanation and analysis, and is available in Adobe Acrobat format on the Internet at: http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf.

[73] Greenbook at pp. 112-13.

[74] *Ibid.*

One proposed recommendation is that a method should be created whereby a life settlement investor can report its "section 101(a)(2) basis" to the insurance company at the time the death benefit claim is filed.[75] In effect, this would provide an accurate number to the insurance company, who would then provide an accurate number to the IRS, eliminating the complications of providing an estimated basis. Unfortunately, this method does not exist in the proposals or in any legislation.

Conclusion

The recent Revenue Rulings provide some much needed guidance regarding tax consequences of life settlement transactions. Many issues that had plagued policy owners and the industry were addressed and the Rulings present some workable solutions. Unfortunately, some questions were left unanswered, and other questions were answered in a manner that gives rise to even more questions. Additionally, by addressing the issues through Revenue Rulings, as opposed to Treasury Regulations, or legislation, the Service sidestepped full vetting of these issues, and left itself vulnerable to criticism and the Rulings vulnerable to legal challenge. The rules set forth in 2009 Revenue Rulings 13 and 14 are illustrated in Table 2 below.

Table 2

Simplified Illustration of 2009 Revenue Rulings 13 and 14

	Policy Owner Tax Ramifications 2009 Revenue Rule 13			Purchaser Tax Ramifications 2009 Revenue Rule 14	
	Situation 1	Situation 2	Situation 3	Situation 1	Situation 2
Situation	Surrender the policy	Sell the policy	Sell the policy	Hold policy to maturity	Resell policy prior to maturity
Policy Type	Has cash surrender value	Has cash surrender value	Term or no surrender value	Term or no surrender value	Term or no surrender value
Cost of Insurance (COI)	Insurer's total policy expense from issue*	Insurer's total policy expense from issue*	Insurer's total policy expense from issue*	(Not Applicable)	(Not Applicable)
Tax Basis	All premiums paid	All premiums paid minus COI	All premiums paid minus COI	Purchase price + all premiums paid	Purchase price + all premiums paid
Cumulative Taxable Income (CTI)	Surrender value minus tax basis	Sale proceeds minus tax basis	Sale proceeds minus tax basis	Death benefit minus tax basis	Sale proceeds minus tax basis
Taxable Ordinary Income	All of CTI	Surrender value minus tax basis	None	All of CTI	None
Taxable Capital Gain	None	CTI minus Ordinary Income	All CTI	None	All of CTI

This table created by Christopher Kampa, Director of Research and Project Development at Insurance Studies Institute.)
*Contact your insurer or insurance agent for the calculation of cost of insurance

[75] Letter from Kirk Van Brunt & Roger D. Lorence to Doug Head, Executive Director, Life Insurance Settlement Association (May 2009) (on file with Insurance Studies Institute).

In some ways, the Rulings are quite helpful. For example, secondary purchasers are now assured that they may include the premiums paid to keep the policy in force when calculating the basis. Similarly, sellers of term life insurance can be assured of capital gain treatment on the sale of policies.

The Rulings did not answer all questions, however. The proper treatment of losses, for example, was not addressed. Nor was the tax treatment of universal or whole life policies in the hands of investors or secondary market purchasers.[76] Similarly, the problem of the proper tax treatment of premium financing is absent from the rulings.[77]

A handful of critical issues addressed by the Rulings raise additional questions, and beg additional analysis or explanation before deference is given to their conclusions. First, it is vital that the IRS deal with the inconsistent treatment of surrenders versus sales. As it stands now, the Rulings favor surrender, without any explanation. This policy choice will force some seniors to surrender policies rather than sell them—a result Congress clearly did not intend. Similarly, the IRS provided no analysis as to why § 1234A does not apply to a policy sale. The language of the section itself does not preclude its application.

Additionally, challenges to the industry regarding estimations, disclosure, and knowing "unknowable" numbers, such as cost of insurance, are prevalent, and potentially problematic. This is especially true when dealing with a foreign investor, but is also an issue with calculation of basis, especially where COI is involved. The differing treatment of calculation of basis is confusing, and burdensome to taxpayers. The burden on taxpayers also has implications for the Service. As IRS Commissioner Doug Shulman recently noted, tax laws that are burdensome, confusing, and poorly understood are especially difficult to enforce.[78]

In their current form, the Rulings should be opposed. We believe that in consideration of all the surrounding issues, parties, and the importance of the settlement industry to the life insurance market and policy owners alike, the tax implications of life settlement transactions could be better addressed in a more formal manner. The Rulings should be withdrawn or put on hold until all interested constituent parties can candidly discuss and analyze the potential tax and economic ramifications of these transactions, not only for seniors themselves, but also for the industry as a whole. Such formal rulemaking would permit important public policy concerns and economic implications to be fully considered. Foreseeable complications such as policy "flipping," personal privacy invasion, and even deflation of the industry must be considered.

ISI believes that seniors should be entitled to equal tax treatment for surrender and sale transactions.[79] Equal treatment would remove the disparate incentives introduced by the Rulings.

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[76] This may however, be an unnecessary issue. *See* footnote 33 *supra*.

[77] Kevin Ring and Paul A. Siegert, *Taxation of Life Insurance Policies in an Evolving Secondary Marketplace* at pp. 7-9 (Insurance Studies Institute, 2008).

[78] Stephen Ohlemacher, *In a reversal, IRS wants to repeal widely ignored tax on personal cell phone calls*, Associated Press, June 17, 2009 (reporting that the Obama administration recently asked Congress to repeal a 1989 law requiring onerous reporting of personal use of company cellular phones).

[79] Kevin Ring and Paul A. Siegert, *Taxation of Life Insurance Policies in an Evolving Secondary Marketplace* at 10 (Insurance Studies Institute, 2008).

ISI believes that the IRS should adopt a standardized method of calculating basis for a settlement transaction—a method that would be predictable and straightforward in its application. ISI supports the increased disclosure requirements posed by President Obama's Greenbook, provided that the disclosure requirements are strict and accurate, rather than simple estimations. Finally, ISI believes that these Revenue Rulings are an improper vehicle for addressing these pressing issues, and that they should be addressed through more formal regulation processes or through Congressional action. Only with input from all affected constituencies can regulations be made that are fair to all interested parties.

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