

## **Life and Disability Insurance Newsletter May 15, 2009**

For over a decade our firm has produced “**Bits and Pieces**” a monthly bulletin geared to our Property & Casualty clients.

On an experimental basis we will be providing a newsletter with items of interest to our life and disability clients. For starters, we will send emails to our clients as we hear of interesting developments.

We invite you to contribute any item of interest or court decision that you believe will benefit other clients. Please forward items to [Blevine@sfl-legal.com](mailto:Blevine@sfl-legal.com) for inclusion in our bulletin. Please indicate in the email whether you would like acknowledgment of the contribution.

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### **The IRS has issued two ruling which impact the taxability of gains realized upon sale or purchase of life insurance in the settlement market**

In Revenue Ruling 2009-13, the IRS analyzed three fact patterns in which the insured neither received distributions nor took out policy loans against the policy, which in the first two scenarios has a cash surrender value and in the third case has no cash value.

In the first case, an individual enters into a life insurance contract, which he surrenders for its cash value. The policyholder paid total premiums of \$64,000, and received \$78,000 on surrender. The IRS ruled that the \$14,000 gain is ordinary because the surrender was not a sale or exchange of the policy (which is required to trigger recognition of capital gain or loss).

In the second scenario, the dollar values were similar to those of the first case, except that the individual sold the policy to a third party. The sales price was \$80,000. The IRS ruled that the insured’s adjusted tax basis in the contract must be decreased by the

cost of insurance (here, \$10,000) during the time the policy was outstanding. The IRS further ruled that the difference between the cash surrender value at the time of the sale (\$78,000) and the policy holder's adjusted tax basis (\$54,000, which was the total premiums paid of \$64,000 less the \$10,000 cost of insurance) is ordinary income. This prong of the ruling was based on case law holding that the "inside buildup" (increase in policy value due to investment of premiums in excess of the cost of insurance and related charges) represented investment income, analogous to a dividend on stock or interest on a bond. After applying this "substitute for ordinary income" rule, only the excess of the sales proceeds above the cash surrender value was treated as long-term capital gain.

The facts of the third scenario differ from those of the first two because in the last case the policy had no cash value. This case involved the sale of a 15 year level - premium policy with a \$500 monthly premium. The policyholder sold the contract to a third party during the fifteenth year of the policy for \$20,000. The ruling holds that the gain on sale is all long-term capital gain, except for one-half of the last-month's premium, which represented the policyholder's tax basis.

### **Taxation of the Secondary Market Holder (Domestic)**

Revenue Ruling 2009-14 also sets out three factual cases. The first is a mirror image of the third case discussed above, involving the sale of a 15 year level - premium policy with no cash value. The insured ("Party A") sold the policy for \$20,000 to a third party ("Party B"), who holds the policy to maturity and receives the \$100,000 death benefit. The ruling concludes that the excess of the death benefit over the basis in the contract (price paid plus premiums paid) is ordinary income because there was no sale or exchange of the policy.

The second scenario is the same as the first case, except that Party B later sells the policy to another third party ("Party C") for \$30,000. Party B paid \$20,000 to acquire the policy and \$9,000 in premiums up to the time of sale to Party C, so his adjusted basis in the contract was \$29,000. The IRS ruled that Party B's profit (here \$1,000) was long term capital gain because there was a sale or exchange of the policy. Because the policy had no cash value, the "substitute for ordinary income" doctrine discussed above was inapplicable.

### **Treatment of Foreign Holders**

The third scenario involves the sale of the policy to a foreign corporation that is not engaged in the trade or business in the United States, but is otherwise the same as the first case. The ruling concludes that all of the gain realized upon the receipt of the death benefits, in this case, \$71,000, is income subject to 30% U.S. withholding tax as "fixed or determinable annual or periodical income" ("FDAP") under Section 881(a)(1) of the Internal Revenue Code.

The ruling requires that any U.S. withholding agent (the life insurance carrier or its paying agent) withhold 30% of the amount of the death benefit in excess of the foreign holder's tax basis in the contract. The U.S. withholding agent will not have any formal

basis to know what that excess amount is: there is no IRS form or other procedure provided in regulations or otherwise for a foreign party such as the one referred to here to provide tax basis information to a withholding agent.

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## **The Securities and Exchange Commission (SEC) is considering regulating life settlement**

Many states have recently passed, or are considering passing, legislation regulating life settlement. SEC Chairman Mary L. Schapiro sent a letter to Sen. Herbert Kohl, D-Wis., who is chairman of the Senate Special Committee on Aging, in which she suggested that the commission will also look at the registration of life settlement providers and brokers.

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## **Must an insurer refund premium if it rescinds a policy?**

Entities which finance life insurance premiums are occasionally faced with insurers who assert that the life insurance application contained false statement and therefore the policies are void. Traditionally, the insurer refunded the premium as part of its claim for rescission. Recently, a number of insurers have asserted that premium does not have to be refunded as the insurer has incurred expenses such as commissions. In an action Between Wells Fargo Bank and Lincoln National Life Insurance Company the United States District Court for the Central District of California recently rejected that argument. A copy of the decision is attached.

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If you know of anyone who would benefit by receipt of this and similar updates please email [blevine@sfl-legal.com](mailto:blevine@sfl-legal.com) with that persons email address.

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