New York State Bar Association

Tax Section

Report on Investor-Owned Life Insurance

December 5, 2008

I. Introduction

This report[1] comments on the federal income taxation of life insurance purchased by investors in the secondary market. More specifically, it addresses tax issues that are raised when a life insurance policy is purchased from an insured (or someone with an insurable interest in an insured) by an investor with no insurable interest. We refer to these policies as "investor-owned life insurance."[2]

As discussed in more detail below, this report addresses three broad federal income tax issues raised by investor-owned life insurance.[3] The first issue is the character of gains or losses on the sale of life insurance policies for both the original policy owner and any successor owner. The second issue is the adjusted basis of investor-owned life insurance for purposes of determining gain or loss. The third issue is the operation of Section 264(f) with respect to investor-owned life insurance.[4] This report recommends that the Treasury Department (the "Treasury") and the Internal Revenue Service (the "IRS") issue guidance that addresses these issues.

This report discusses the federal income treatment of investor-owned life insurance under current law. It does not attempt to harmonize the tax treatment of investor-owned life insurance

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[1] This report was prepared by an ad hoc working group of the New York State Bar Association Tax Section consisting of Micah W. Bloomfield, John T. Lutz, Douglas R. McFadyen, David S. Miller, Maureen Nelson, Andrew P. Solomon, and W. Kirk Wallace. The principal author of this report is John T. Lutz, with assistance from Christopher Lovejoy and Shlomo Boehm. Substantial and helpful comments were received from Robert Cassanos, Peter J. Connors, Craig Farber, Michael Farber, Erika W. Nijenhuis, Andrew L. Oringer, James M. Peaslee, Peter Ritter, Michael L. Schler and Willard B. Taylor.

[2] Investor-owned life insurance policies are also known as "life settlements."

[3] This report does not address the policy implications of investor-owned life insurance. See "Late in Life, Finding a Bonanza in Life Insurance," The New York Times, December 17, 2006.

[4] All references to "Section" or "Sections" are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder, unless otherwise noted.

with the tax rules that apply to similar investments in financial instruments. Also, this report does not address the application of the split dollar regulations to investor-owned life insurance.[5]

II. Summary of Recommendations

1. We recommend that the IRS and Treasury clarify that Section 1234A does not apply to amounts received under a life insurance policy from the insurance company when the policy matures upon the death of the insured, or is surrendered or cancelled. Absent an actual sale or exchange, amounts received under an investor-owned life insurance policy upon surrender or cancellation should be taxable as ordinary income.

2. We recommend that the IRS and Treasury adopt a bifurcated approach as to the character of income realized on the sale of a life insurance policy in the secondary market. Under this approach, the amount of gain realized on the sale would be ordinary income to the extent of the policy's cash surrender value and any additional amounts would be treated as capital gains.

3. We recommend that the IRS and Treasury confirm that a secondary market investor in life insurance acquires a basis in the policy equal to the sum of the purchase price and the aggregate premiums paid on the policy (without reduction for amounts allocated to the "cost of insurance").

4. We recommend that the IRS and Treasury confirm that the phrase "loan in respect of such policy or contract" under Section 264(f) includes indebtedness in respect of the policy for which

[5] The split dollar regulations may permit investors to structure investments in life insurance policies as indebtedness under the split dollar regulations. We would be pleased to address the application of the split dollar regulations to investments in life insurance policies in a separate report.

interest expense is denied under Section 264(a) to ensure taxpayers do not suffer double disallowances of interest expenses.

B. History

Since the enactment of the income tax in 1913, amounts received under a life insurance policy paid by reason of death of the insured generally have been excluded from income. Under Section 213 of the Revenue Act of 1918, gross income of individuals did not include "the proceeds of life insurance policies paid upon the death of the insured to individual beneficiaries or to the estate of the insured."[6] However, secondary market purchasers of life insurance policies have not benefited from the exclusion. For example, in 1926, Congress denied the exclusion for proceeds on policies that were transferred for valuable consideration to a third party by assignment or otherwise.[7] In 1954, the House of Representatives proposed to delete the transfer for value provision, but the Senate Finance Committee was concerned that eliminating the restriction would "result in abuse in encouraging speculation on the death of the insured."[8] Today, Section 101(a)(2) provides that amounts payable by reason of death of the insured are excluded from the gross income of a transferee for value of a life insurance policy only to the extent the death benefit payments do not exceed the sum of the transferee's cost to acquire the policy from the transferor, the aggregate premiums paid by the transferee after acquisition, and certain other amounts, including interest expense whose deduction was disallowed under Section 264(a)(4).

[6] Internal Revenue Code of 1918, ch. 18, 40 Stat. 1057 (1919).

[7] See S. Rep. No. 52, 69th Cong., 1st Sess. (1926). In enacting the restriction, Congress provided no rationale.

[8] See S. Rep. No. 1622, 83d Cong., 2d Sess. 14 (1954). In reinstating the provision, the Senate Finance Committee added an exemption for contracts "which have been transferred for certain legitimate business reasons rather than for speculation purposes." See id.

Historically, there has not been a secondary market in insurance and therefore a holder of a life insurance policy has had limited choices: to continue to pay premiums until the policy matured upon the death of the policy holder, to restructure the policy with the insurance company, allow the policy to lapse, or to surrender the policy to the insurance company. In recent years, however, a secondary market for life insurance policies has emerged. Policy holders may now sell in-force life insurance policies in an active and competitive secondary market maintained by institutional investors.[9]

With the emergence of the secondary market for life insurance policies, policies are now often sold at their fair market value for amounts substantially in excess of the policies' cash surrender values.[10] In these transactions, the purchaser names itself the beneficiary under the policy and is responsible for all future premium payments. The life settlement purchaser will have thus acquired a valuable financial asset with the right to a payment under the life insurance policy.[11]

According to an October 9, 2007 press release by Conning Research and Consulting, in 2006 investment in life settlement assets increased to $6.1 billion dollars, up from $5.5 billion in 2005.[12] Further, Conning Research anticipates that the volume of life settlement transactions will increase by about $1 billion per year for the foreseeable future, reaching an estimated $15 billion in 2016. Although this number represents only a fraction of the estimated $18.4 trillion of

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[9] See Kevin Ring and Paul A. Siegert, Taxation of Life Insurance Policies in an Evolving Secondary Marketplace, Insurance Studies Institute 2 (March 3, 2008).

[10] Id.

[11] Id.

[12] Press Release, Conning Research & Consulting, Conning Research: Annual Life Settlement Volume Rises to $6.1 billion in 2006 (Oct. 9, 2007).

individual life insurance policies in force as of the end of 2005,[13] it has been significant enough to cause legislators and regulators to devote substantial efforts to regulate the life settlement industry.

As a result of the rapidly growing and evolving secondary market for life insurance policies as investments, the tax issues relating to the sale of life insurance policies have become increasingly important.[14] The current scheme of taxation related to the sale of life insurance policies is unclear and the existing authorities often fail to provide a cogent methodology for computing the appropriate tax.

III. Character on the Sale of a Policy

When a life insurance policy holder transfers a policy, whether by surrender or sale, the policy holder may realize gain on the transfer. The character of the gain is not always clear, because tension exists between the treatment of life insurance policies as capital assets under Section 1221 and the statutory rules applicable to payments under insurance contracts, in particular Sections 72 and 101. Although Section 72 does not contain specific rules identifying the character of amounts that must be included in gross income under Section 72, courts have treated the income as ordinary, either because there was no sale or exchange as required by Section 1221 or because the amounts realized were attributable not to any appreciation of the

[13] Understanding Life Settlements and Industry Issues Entering 2008, Insurance Studies Institute 2 (Jan. 22, 2008) (citing American Council of Life Insurers – 2006 Life Insurance Fact Book).

[14] Several commentators have already written on the issues presented by investor-owned life insurance. See, e.g., David H. Shapiro, Vulture Capital Tax Manual – A Brief Guide to the Tax Issues Associated with Financial Investments in Life Settlements, J. Tax'n of Fin. Prod. (CCH) Vol. 6, No.3 (Winter 2007); Mitchell M. Gans and Jay A. Soled, "A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference," 7 Fla. Tax Rev. 569 (2006).

property sold but instead constituted compensation for the assignment to the purchaser of the income on the contract contained in the cash surrender value of the policy.[15]

A. Holding Life Insurance Policies to Maturity

Under Section 101(a)(2) a transferee for value may exclude from taxable income an amount of death benefit equal to the amount the transferee paid to acquire the policy plus the premiums paid by the transferee on the policy and any interest expense disallowed under Section 264(a)(2). Section 101, however does not address the character of amounts received by reason of the death of the insured that exceed a transferee's purchase price plus aggregate premiums paid and interest expense disallowed under Section 264(a)(2). Death benefit income received on an insurance policy upon the death of the insured should be treated as ordinary income. More specifically, Section 1222 requires a "sale or exchange" of a capital asset for capital gains treatment. While life insurance policies are "capital assets" under Section 1221 (as discussed below in Part II.C.), a death benefit payment by the insurance company does not result in a "sale or exchange" for purposes of generating capital gains or losses.[16]

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[15] See Bodine v. Comm'r, 103 F.2d 982 (3d Cir. 1939) (surrender of a life insurance policy to the insurance company did not meet sale or exchange requirement for capital gain treatment); First Nat'l Bank of Kansas City v. Comm'r, 309 F.2d 587 (8th Cir. 1962) (finding that the amount received on a sale of a life insurance policy in excess of the premiums paid (i) did not represent an appreciation in the value of a capital asset, and (ii) would have been treated as ordinary if held to maturity, thus finding the resulting excess income to be ordinary); Bolling Jones, Jr. v. Comm'r, 39 T.C. 404 (1962) (same); Nesbitt v. Comm'r, 43 T.C. 629 (1965) (the Tax Court stated that gain on a sale of a life insurance policy was ordinary income "as defined by Section 72(e)"); Estate of Crocker v. Comm'r, 37 T.C. 605 (1962) (gain on sale of policy taxed as ordinary income because the gain was due to accrued interest).

As discussed below, Section 1234A may affect the analysis of the character of gain upon the transfer of a life insurance policy. However, since Section 1234A was enacted, there have been no cases addressing the character of the income received when a policy is sold for an amount in excess of the cash surrender value.

[16] In the context of bond redemptions, the Supreme Court held in Fairbanks v. United States that a redemption by a bond issuer was not a "sale or exchange," and that gain on such a redemption, even though attributable to the increase in value of a capital asset, was not entitled to capital gains treatment. See Fairbanks v. U.S., 306 U.S. 436, 437 (1939). Of note, Section 1271(a)(1) (permitting capital gains treatment in the context of debt surrender), while enacted at the time of Fairbanks, was not applicable to the tax year at issue. See also Leh v. Comm'r, 260 F.2d 489

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B. Surrenders and Cancellations of Life Insurance Policies

Section 72(a) provides that, as a general rule ,"gross income includes any amounts received as an annuity . . . under an annuity, endowment, or life insurance contract." Section 72 does not apply, however, to amounts paid under the contract by reason of death of the insured.[17] Section 72(e) addresses the treatment of amounts received under an annuity, endowment, or life insurance contract that are not received as an annuity, such as amounts paid upon partial or complete surrender of a policy. The general rule of Section 72(e) is that if the amount is received on or after the "annuity starting date" (which as a practical matter will never be the case with respect to amounts received under a life insurance contract), it is included in gross income.[18] In the case of amounts not received as an annuity that are received before the annuity starting date, such as proceeds of a surrender of a policy, Section 72(e)(2)(B) expressly provides that amounts received "(i) shall be included in gross income to the extent allocable to income on the contract and (ii) shall not be included in gross income to the extent allocable to the investment in the contract." Section 72(e)(3)(A) restricts the amount treated as "income on the contract" to the amount by which "(i) the cash value of the contract (determined without regard to any surrender charge) immediately before the amount is received" exceeds "(ii) the investment

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(9th Cir. 1958) (capital gain treatment denied for amounts received as a result of a "termination" of a gasoline contract); Comm'r v. Pittston Co., 252 F.2d 344 (2d Cir. 1958) (capital gain treatment denied for amounts received upon "surrender" of exclusive purchase contract); Bodine v. Comm'r, 103 F.2d 982 (3d Cir. 1939) (surrender of a life insurance policy was not a sale or exchange for purposes of capital gain treatment).

[17] Treasury Regulations Section 1.72-2(b)(1)(i) provides that Section 72 applies to "any amounts received under the contracts described in paragraph (a)(1) [of this section]. However, if such amounts are specifically excluded from gross income under other provisions of chapter 1 of [the Code], section 72 shall not apply for the purpose of including such amounts in gross income. For example, section 72 does not apply to amounts received under a life insurance contract if such amounts are paid by reason of death of the insured and are excludable from gross income under section 101(a)."

[18] See Section 72(e)(2)(A).

in the contract at such time."[19] Section 72(e) applies to the surrender of a life insurance policy for its cash surrender value, but is silent as to amounts paid by an insurance company in excess of the policy's cash surrender value.

Courts have consistently held that the surrender or redemption of a life insurance policy does not involve a sale or exchange.[20] Therefore, because there is no sale or exchange upon the surrender or redemption of a life insurance policy, these amounts are presumably ordinary income to the surrendering policyholder.

Section 1234A was enacted subsequent to the cases holding that the surrender of a life insurance policy does not give rise to a sale or exchange. Because Section 1234A provides capital gain treatment upon the termination of a right with respect to "property which is . . . a capital asset," an argument can be made that a life insurance policy, as "property," represents an obligation with respect to itself such that Section 1234A applies.[21]

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[19] With regard to an original policy holder's "investment in the contract" for purposes of determining taxable income on the surrender of a policy, Code section 72(e)(6) dictates that a policy holder's "investment in the contract" is equal to the aggregate premiums paid under the policy and includes both the premiums paid to achieve a cash surrender value and premiums paid that would be allocable to the cost of insurance.

[20] See Bodine v. Comm'r, 103 F.2d 982 (surrender of a life insurance policy was not a sale or exchange for purposes of capital gain treatment); Avery v. Comm'r, 111 F.2d 19 (9th Cir. 1940). When taxpayers have attempted to obtain the cash surrender value of their policies by selling them to third parties, courts have held that the gains realized were still properly treated as ordinary income because they were not attributable to any inherent appreciation in the value of the underlying policies but were instead compensation for the assignment to the purchasers of the income on the contracts to which the sellers were entitled. See, e.g., First National Bank of Kansas City v. Comm'r, 309 F.2d 587 (8th Cir. 1962); but see Jules J. Reingold, B.T.A. Memo (RIA) 1941-319 (holding that a taxpayer received capital gains when the taxpayer purchased a matured life insurance policy from a beneficiary who was later adjudged incompetent and in settlement the taxpayer transferred the policy to the beneficiary's conservators because the policy was a capital asset in the purchaser's hands and the transfer to the conservators was a sale or exchange).

[21] At least one commentator has noted the argument that a life insurance policy is "property with respect to itself" is misplaced due to the fact that Section 1234A(2) applies Section 1234A to Section 1256 contracts that are not described in Section 1234A(1), but are nonetheless "capital assets" in the hands of the taxpayer, and if every contract were "property with respect to itself," Section 1234A(2) would be unnecessary. See, e.g., Shapiro, supra note 12 at 4 n. 33.

Technical Advice Memorandum 2004-52033[22] (the "2004 TAM") involved the treatment of gains realized by a taxpayer upon surrender of its life insurance contracts on its employees ("corporate owned life insurance" or "COLI"). The COLI contracts provided that the taxpayer could terminate the contract and receive an amount equal to the cash value of the contracts, which the taxpayer did. The taxpayer and the IRS executed a closing agreement resolving the adjustments to tax associated with the disallowance of interest expense reported in connection with acquisition of the policies. In the closing agreement, the parties agreed that only a portion of the amount "otherwise includable in gross income under [S]ection 72" as a result of the termination and surrender of the contracts was includable in the corporation's gross income. However, the closing agreement did not specify the character of the amounts to be included in income by the company. The taxpayer appears to have argued that the insurance policies were capital assets, and that any gain realized upon surrender of the policies in excess of the company's basis should be treated as a capital gain.

In the 2004 TAM, the IRS rejected the application of Section 1234A to the gains realized by the taxpayer when the insurance company paid the taxpayer the cash surrender value of the policies. In its analysis, the IRS observed that Section 1234A applies only with respect to property that is a capital asset. Therefore, because income accretions to a capital asset are not themselves capital assets under Section 1221,[23] the IRS concluded that Section 1234A does not apply to any amounts received with respect to such income accretions. Because the IRS limited

[22] (December 26, 2004).

[23] The 2004 TAM cites Commissioner v. Gillette, 364 U.S. 130 (1960), U.S. v. Midland-Ross Corp, 381 U.S. 54 (1965), and Arkansas Best Corp v. Commissioner, 485 U.S. 212 (1988) for the proposition that the Supreme Court has "consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves attributable to income." Midland-Ross, 381 U.S. at 57.

its rejection of the application of Section 1234A to the taxpayer's gains "to the extent [that] amounts received by Taxpayer upon the surrender of the Contracts are attributable to ordinary income accretions to the Contract's value," the TAM suggests that Section 1234A may apply to any amounts realized in excess of the cash surrender value of the contract immediately before the surrender of the contract. As a practical matter, however, an insurer would never pay more the cash surrender value upon the surrender of a contract. Therefore, the TAM implies that Section 1234A never applies to the surrender or maturity of a life insurance contract.

The character of a payment received upon a surrender of a policy has almost universally been treated by the courts as ordinary, and there is no evidence that Congress intended to overturn this treatment when it enacted Section 1234A. Therefore, we recommend that the IRS confirm that Section 1234A does not apply to the surrender or maturity of a life insurance contract.

C. Sales of Life Insurance Policies

Life insurance contracts have consistently been viewed as "capital assets"[24] in the hands of the insured.[25] As discussed below, while courts have held that policies are "capital assets" in

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[24] Section 1221 defines a "capital asset" as "property held by the taxpayer." Treasury Regulations Section 1.1221-1 states that "the term 'capital assets' includes all classes of property not excluded by section 1221." Section 1221 does not exclude life insurance contracts from the definition of "capital asset."

[25] See Phillips v. Comm'r, 275 F.2d 33, 37 n.3 (4th Cir. 1960) (indicating that a life insurance policy may be a capital asset in certain circumstances); First Nat'l Bank of Kansas City v. Comm'r, 309 F.2d 587, 588 (8th Cir., 1962) (stating that the policies may be capital assets, but "gain" realized upon the sale was attributable to the sale of the right to the ordinary income credited to the policy value and was therefore ordinary income); Keystone Consolidated Pub. Co. v. Comm'r, 26 B.T.A. 1210 (1932) (an insurance policy has two parts, the cost of insurance which is not a capital asset, and the cash surrender value which is a capital asset); see also Bolling Jones v. Comm'r, 39 T.C. 404 (1962) (relying on section 72(e) to determine that a taxpayer cannot convert income that would otherwise be received as ordinary income by casting the transaction as a sale of a capital asset); Gallun v. Comm'r, T.C. Memo. (RIA) 1963-167, aff'd 327 F.2d 809 (7th Cir. 1964) (same as Kansas City); Estate of Nesbitt v. Comm'r, 43 T.C. 629 (1965).

the hands of the insured, these courts have also found that gain on a sale is ordinary income under the "substitution of income" doctrine that applies when a taxpayer is attempting to convert what would otherwise be ordinary income into capital gain through the sale of a capital asset.

This Part discusses three possible methods of taxing investors upon the sale of a life insurance policy. Under one method, the taxpayer would realize only ordinary income on the sale. Under the second method, the taxpayer would realize only capital gain on the sale. Under the third method, the amount of gain realized on the sale would be ordinary income to the extent of the policy's cash surrender value and any additional amounts would be treated as capital gains. The three possible alternatives are analyzed below, with our recommendation that the third method be adopted.

1. All Income Received on the Sale is Ordinary Income

The Supreme Court has held that capital gain treatment is inappropriate where the amount received is a substitute for ordinary income.[26] A number of cases have held that ordinary income is realized upon the sale or exchange of a life insurance contract to a third party shortly prior to its maturity based on the theory that the sale or assignment is an "anticipatory assignment of income," and income earned on the internal build-up of a life insurance contract is normally taxable as ordinary income under Section 72(e).[27] In none of these cases, however, did the amount realized exceed the cash surrender value of the policy at the time of the sale.

[26] See Arkansas Best Corp. v. Comm'r, 485 U.S. 212 n. 5 (Section 1221 property excludes income items or accretions to the value of a capital asset properly attributable to ordinary income); Comm'r v. Gillette Motor Co., 364 U.S. 130 (1960); U.S. v. Midland-Ross Corp., 381 U.S. 54 (1965); Comm'r v. P.G. Lake, Inc., 356 U.S. 260 (1958); Hort v. Comm'r, 313 U.S. 28 (1941).

[27] See Arnfeld v. U.S., 163 F.Supp. 865 (Ct. Cl. 1958) (finding that, regardless of the fact that the taxpayer transferred her entire ownership in an income-producing capital asset, the sale of a life insurance contract produced

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For example, in Gallun v. Commissioner,[28] a taxpayer sold life insurance policies for their cash surrender values to a corporation that he controlled. The Seventh Circuit adopted the reasoning of the Tax Court[29] and applied the "assignment of income" doctrine to find that the gain received on the sale was ordinary. The Seventh Circuit held that Section 72(e) did not apply because that section was applicable only to amounts received "under" an insurance policy, and not to the sale of the policy. Nevertheless, the court determined that, in light of Section 72(e), Congress did not intend to permit the conversion of ordinary income into capital gain, especially in a tax avoidance transaction (as was the case in Gallun). The IRS also adopted this stance in Nesbitt v. Commissioner, and the Tax Court agreed that "gain on the sale of three endowment policies . . . is determined to be ordinary income as defined by section 72(e) of the Internal Revenue Code of 1954. It is held that this is not within the purview of section 1221 of the Internal Revenue Code of 1954." Thus, while Section 72(e) is, by its terms, inapplicable to sales of policies, several cases have held that when a sale is made immediately prior to the receipt of amounts to be received "under" the policy the gains are taxable as ordinary income under Section 61.

Treating income received on the sale of a life insurance policy as ordinary income is consistent with the substitution of income doctrine and is easy for the IRS and courts to

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ordinary income because, had there been no sale, the resulting income would have been ordinary); First Nat'l Bank of Kansas City v. Comm'r, 309 F.2d 587 (8th Cir. 1962) (finding that the amount received on a sale of a life insurance policy in excess of the premiums paid did not represent an appreciation in the value of a capital asset, and that such gain would have been treated as ordinary if held to maturity, thus finding the resulting excess income to be ordinary); Bolling Jones, Jr. v. Comm'r, 39 T.C. 404 (1962) (same); Nesbitt v. Comm'r, 43 T.C. 629 (1965) (IRS stated that gain on a sale was ordinary income "as defined by Section 72(e)"); Estate of Crocker v. Comm'r, 37 T.C. 605 (1962) (gain on sale of policy taxed as ordinary income because the gain was due to accrued interest); Gallun v. Commissioner, 327 F.2d 809 (7th Cir. 1964).

[28] 327 F.2d 809 (7th Cir. 1964).

[29] Edwin A. Gallun, T.C. Memo (RIA) 1963-167.

administer. However, as discussed below, the facts of the cases addressing this issue all involve sales for an amount equal to the cash surrender value of the policy. In the secondary market, a purchaser of a life insurance policy may purchase a policy for more than the policy's cash surrender value because that purchaser believes the cash surrender value of the policy does not reflect the policy's actual economic value. Thus, while case law has established that a sale of a life insurance policy for its cash surrender value results in ordinary income to the seller, if the seller receives an amount greater than the cash surrender value, an argument may be made that the excess gain is entitled to capital gains treatment.

2. All Income Received on the Sale is Capital Gain

Because courts have held that life insurance contracts are "capital assets," at least in the hands of the insured, an argument may be made that, in the context of a sale or the policy, the appreciation on the policy is not appreciation attributable to ordinary income. In Phillips v. Commissioner,[30] a taxpayer sold an endowment policy for less than the policy's cash surrender value in order to convert what would otherwise be treated as ordinary income on the maturity or surrender of the contract into capital gains. The Phillips court held that because the gain would have been ordinary upon the maturity or surrender of the contract, even a bona fide sale could not convert the gain to capital gain. However, the court suggested that in certain circumstances when a policy is sold, capital gain treatment may be appropriate.[31]

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[30] 275 F.2d 33 (4th Cir. 1960).

[31] Phillips v. Comm'r, 275 F.2d 33, 37 n.3 (4th Cir. 1960) ("for example, if a policyholder had an amount receivable thereunder which was in excess of his cost, but policyholder was afflicted with a disease which would result in his death in the near future, he could, if in need of cash, assign his policy for an amount in excess of that receivable under the policy, and, as to such excess, treat the same as a capital gain.").

Section 72(e)(2) provides that amounts shall be included in gross income "to the extent allocable to income on the contract." In turn, Section 72(e)(3) provides that amounts are treated as allocable to income on the contract only "to the extent that such amount does not exceed the excess (if any) of the cash value of the contract . . . immediately before the amount is received over the investment in the contract . . . ." This language suggests that amounts received in excess of the cash value are not "income on the contract" and are not included in gross income by reason of Section 72. While other sections of the Code may include these amounts in gross income, this language arguably leaves the door open for treatment of the amounts in excess of cash surrender value as capital gain.

This capital gains approach holds some appeal because the value of a policy in the secondary market is not primarily based upon the policy's cash surrender value. Rather, any increase in value of the policy when sold in the secondary market is attributable to the age and health of the insured and the credit risk of the insurance company. The value of the policy is not generally tied to the investment earnings on the policy's reserves, which would be ordinary income.

However, from a policy perspective, the substitution of income doctrine should apply to owners of life insurance policies who sell their policies shortly prior to the receipt of payment to avoid recognition of ordinary income and the authority discussed in the prior section holds that the sale of a life insurance policy results in ordinary income to the seller up to the cash surrender value of the policy. Therefore, we do not believe that existing law supports treating all gain on the sale of an insurance policy as capital gain.

3. Income Received on the Sale of a Policy Is Ordinary up to the Cash Surrender Value and Any Excess Is Capital Gain

As discussed above, case law supports ordinary income treatment when a policy is sold by a policy holder shortly before the right to receive ordinary income arises. However, because life insurance policies purchased by investors have a capital investment aspect, ordinary income treatment is not necessarily the most logical result when policies are purchased as an investment and are sold on the secondary market. Section 72(e) itself illustrates that Congress intends to tax amounts received in excess of the taxpayer's "investment in the contract" as ordinary income when the policy is surrendered or redeemed. However, Section 72(e) assumes that the amount received on the surrender will be the cash surrender value and is silent regarding amounts realized in excess of the cash surrender value.

When life insurance policies are sold on the secondary market, the value ascribed to the policies is not based solely on the cash surrender value of the policy. The market itself dictates the value of life insurance policies based on the likelihood and time of payment on the policies, which is in turn based on the credit risk of the insurance company, actuarial tables, and other relevant information such as the age and health of the insured. A policy's cash surrender value, conversely, is dependent on the internal build-up of interest on the taxpayer's investment, which would traditionally be taxable as ordinary income.

Treating gains received on the sale of a life insurance policy in the secondary market as ordinary income to the extent of the cash surrender value would be consistent with the policy that a taxpayer should not get a better result from selling a policy than surrendering it in a transaction governed by Section 72. Any excess received above the cash surrender value, however, is more logically treated as capital gain because this treatment better reflects the increase in the policy's value based on a change in the factors discussed above.[32]

The IRS provided support for this theory in private letter ruling 9443020.[33] The private letter ruling addressed the amount realized by a taxpayer who assigned a policy he owned on his life to a viatical settlement company for roughly 63 percent of the contract's face value. The ruling found that the amount realized by the taxpayer was equal to the amount received less the adjusted basis of the contract. The IRS indicated that the adjusted basis of the contract equaled the premiums paid less the sum of the cost of insurance protection and any amounts received under the contract that were not includible in gross income.

Most notably, as authority for its conclusion, the letter ruling cited Section 1016(a)(1) regarding basis adjustments for items chargeable to capital accounts (along with Section 72(e)).[34] The citation to Section 1016 indicates that the IRS considered the life insurance policy as a "capital asset," and that amounts received on the sale of the policy may, in certain circumstances, produce capital gain.[35] This citation is consistent with the language in Phillips to the effect that when a policyholder sells, or assigns his policy for cash for an amount in excess of the policy's cash surrender value, capital gains may be appropriate.

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[32] See also Treas. Reg. Section 1.263(a)-4 (stating that the cost to acquire an insurance contract is to be capitalized).

[33] (October 28, 1994).

[34] Priv. Ltr. Rul. 9443020 n. 5.

[35] Private Letter Ruling 9443020 refused to adopt Section 72(e)'s "investment in the contract" approach (which has no negative adjustment for the cost of insurance) when the policy was sold for less than its cash surrender value. Accordingly, any gain on the sale of the policy would not necessarily be ordinary (unlike Section 72(e)'s directive). Thus, while not addressing the character of the gain from the sale of a policy, private letter ruling 9443020 provides support for the notion that capital gain treatment would be appropriate had a gain been realized.

Finally, case law indicates that "simply because the property transferred will produce ordinary income, and such income is a major factor in determining the value of the property, does not necessarily mean that the amount received for the property is essentially a lump-sum substitute for ordinary income."[36] All of the cases that held that a taxpayer who sold a life insurance policy recognized ordinary income involved taxpayers who sold their policies at the policy's cash surrender value.

Therefore, we recommend that the amount of any gain on the sale of a life insurance policy should be treated as ordinary income to the extent of the policy's cash surrender value and any additional amounts should be treated as capital gain.[37]

IV. Determining Basis on the Sale of a Life Insurance Policy

Sections 72 and 101(a)(2) address the treatment of death benefits upon the surrender of the policy to the insurance company. However, when an investor sells a policy on the secondary market, it is unclear whether the investor may include in its basis the aggregate premiums paid after it originally acquired the policy. We believe that these premiums should be included in the

[36] See e.g. Guggenheim v. Commissioner, 46 T.C. 559, 569 (1969).

[37] We note that this bifurcation approach has collateral consequences with regard to withholding under Section 1441, unrelated business taxable income under Section 511, and Subpart F income. More specifically, capital gain realized by a foreign individual or corporation is not generally subject to withholding, is generally excluded from unrelated business taxable income, and net gains from the sale or exchange of certain property is generally treated as Subpart F income. However, these consequences follow generally from the treatment of an item as capital gain and are not specific to insurance. Any increase in the value of the a life insurance policy is similar to other instruments, such as preferred stock, that generate capital gains on sale.

We also acknowledge that the bifurcation approach we suggest may result in character asymmetry (i.e., the gains will be ordinary to the extent of the policy's cash surrender value and the amount received above the cash surrender value will be capital, while all of the losses should be capital losses). Because character symmetry may be preferable to the Treasury and IRS, one option may be to treat all gain on the sale of a life insurance policy in the secondary market as capital. However, as mentioned above, this approach appears to contradict the express language of Section 72(e) and case law and may require legislative change.

policy holder's basis without reduction for amounts attributable to the cost of insurance protection.

A. Statutory Guidance

On a sale of property, the amount of gain or loss realized by a taxpayer is the difference between the amount realized and the property's adjusted tax basis.[38] The adjusted basis in property is the property's cost, adjusted upward to reflect capital outlays and downward to reflect tax deductions and tax-free receipts generated by the property.[39] "Cost" is defined under the applicable Treasury Regulations as "the amount paid for such property in cash or other property."[40]

Calculation of a life insurance contract's adjusted basis must begin with the amount paid for the contract in cash or other property. However, the Code does not specifically address how the adjusted basis in a life insurance contract is to be determined for purposes of calculating gain or loss on a sale of the contract. Thus, for secondary market purchasers of life insurance policies, the critical question is whether their basis in the contract will increase by the amount of premiums paid under the policy post acquisition.

Treasury Regulations Section 1.263(a)-4(b)(1)(i) requires capitalization of amounts paid to acquire or create an "intangible." Under the regulations, an insurance contract is an "intangible."[41] Further, the regulations also require capitalization of amounts paid to "enhance a

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[38] See Section 1001(a).

[39] See Sections 1011, 1012, 1016.

[40] Treas. Reg. Section 1.1012-1(a).

[41] Treas. Reg. Section 1.263(a)-4(c)(iv)

separate and distinct intangible asset."[42] A "separate and distinct intangible asset" is a property interest of measurable monetary value that is subject to protection under state, federal or foreign law and which is capable of being sold separate and apart from a trade or business."[43] Likewise, under Treasury Regulations Section 1.263(a)-4(d) a taxpayer must capitalize amounts paid to create an "an insurance contract that has or may have cash value."

Section 264(a)'s disallowance of deductions for premiums paid by a beneficiary of the policy does not alter the capitalization of amounts paid to acquire a life insurance policy on the secondary market. Section 264(a) explicitly provides that premiums paid by a beneficiary of a life insurance policy are nondeductible. This ban on deductibility of premiums paid by a beneficiary is also mentioned in the regulations under Section 262 with regard to the non-deductibility of personal, living, and family expenses.[44] The policy rationale for the prohibition on deductions for premiums paid by a beneficiary is rooted in two conceptually separate regimes. First, premium payments by an individual for a policy on his or her life are not generally deductible under the Code because they are personal expenditures. Second, the death benefits paid under a life insurance contract are specifically excluded from income of the beneficiary under Section 101(a); allowing a deduction for premiums paid would permit taxpayers a tax windfall.

A secondary market purchaser of a life insurance policy acquires the policy as an investment asset. The premium payments made by such purchaser are similar to investment

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[42] Treas. Reg. Section 1.263(a)-4(b)(1)(iii).

[43] Treas. Reg. Section 1.263(a)-4(b)(3). Additionally, under the regulation section "a fund (or similar account) is treated as a separate and distinct intangible asset of the taxpayer if amounts in the fund (or account) may revert to the taxpayer."

[44] See Treas. Reg. § 1.262-1(b).

costs to build value in the investment. A secondary market owner of a life insurance policy is taxable on the death benefits received on the policy under Section 101(a)(2), a fact that does not implicate the policy reflected in Section 264(a) against permitting a windfall to a taxpayer receiving death benefits. Thus, giving a secondary market owner of a life insurance contract a basis equal to the aggregate premiums paid under the policy, without reduction for the cost of insurance protection, does not frustrate the Congressional intent of Section 264.

Sections 72 and 101 provide that the person who holds a policy reduces income received on or under the policy by the aggregate premiums paid on the policy, which is analogous to giving the policy holder a basis in the contract equal to the aggregate premiums paid. For Section 72 purposes, a taxpayer's recognition of income is limited to the excess of cash surrender value over the premiums paid. In other words, under Section 72, an owner of a life insurance policy does not recognize income in the case of the surrender of the policy unless the amount received upon a refund, surrender, or redemption exceeds the *aggregate* premiums paid.[45] (Both premiums paid to achieve a cash surrender value and premiums paid that are allocable to the cost of insurance.) While Section 72(e), by its terms, does not apply to the *sale* of life insurance contracts, it indicates Congress' intent that the aggregate premiums paid, without reduction for the cost of insurance, should reduce income recognized by taxpayers who surrender policies.)

Similarly, for purposes of determining income recognition under Section 101(a)(2), a transferee for value receives "credit" for all of the premiums paid and not only the premiums in excess of the cost of insurance. The transferee takes a basis in the transferred life insurance policy equal to the purchase price of the policy plus any subsequent premium payments made

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[45] See Section 72(e)(5) and (6).

under the policy. Thus, when the death benefit is paid out, the income recognized by the transferee is excluded to the extent of the transferee's economic investment in the life insurance policy. Section 101(a)(2) demonstrates Congressional intent to tax investors an investment only on their investment; a secondary market owner's basis in a life insurance policy does not appear to be reduced by the cost of insurance protection under Sections 72, 101, or 264.

B. Case Law Interpreting Basis When a Policy Is Sold for Gain or Loss

When a taxpayer has sold a policy for gain, courts have held that the taxpayer's basis in the policy for purposes of determining gain is equal to the aggregate premiums paid by the taxpayer on the policy.[46] While these cases are more frequently analyzed and cited for the proposition that income from the sale of a life insurance policy is ordinary income, the cases hold that the taxpayer's gain on the sale is equal to the excess of the amount received over the aggregate premiums paid.

For example, in Estate of Crocker v. Commissioner,[47] the Tax Court held that gain from the sale of a life insurance policy for an amount less than the cash surrender value but more than the aggregate premiums paid on the policy resulted in ordinary income to the taxpayer because the gain was attributable to interest accumulated on the contract at fixed and predictable rates. The IRS argued that the gain on the sale was equal to the difference between the amount received by the taxpayer and the assumed "cost" of the policies, which was the aggregate

[46] See Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960); Gallun v. Comm'r, 327 F.2d 809 (7th Cir. 1964); Nesbitt v. Comm'r, 43 T.C. 629 (1965); Estate of Crocker v. Comm'r, 37 T.C. 605 (1962); Neese v. Comm'r, T.C. Memo. (RIA) 1964-288.

[47] 37 T.C. 605 at 608.

premiums paid on the policies, an argument with which the Tax Court agreed.[48] The IRS took this same position in Nesbitt v. Commissioner and prevailed as well.[49]

Early case law found that this policy extended to loss cases as well. In Lucas v. Alexander,[50] a taxpayer surrendered his life insurance policy in exchange for the cash value of the policy. The issue before the United States Supreme Court was the amount of gain on the policies that accrued prior to the enactment of the income tax in 1913, and was thus excluded from tax. The Court found that the taxpayer's gain was the excess of the proceeds from the policy over the premiums paid under the policy, and stated, "[b]y the expenditure of $78,100 in premiums, the insured secured a return of $120,797, resulting in an economic and realized [] gain to him of $42,697."

The decision in Lucas was interpreted by a Massachusetts district court a year later as establishing a rule that the total premiums paid on a policy offset a taxpayer's amount realized, regardless of whether the taxpayer realized a gain or loss on the sale of the policy.[51] In Forbes Lithograph Manufacturing Company v. White, the district court allowed the taxpayer to recognize a $18,000 loss when he surrendered a life insurance policy for $23,000 on which he had paid $41,000 in premiums. This holding did not stand the test of time, however.

The conclusion in Forbes was explicitly rejected by the Board of Tax Appeals several year later in Keystone Consolidated Publishing Co. v. Commissioner.[52] In Keystone, a taxpayer

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[48] See id. at 609.

[49] See Nesbitt, 43 T.C. at 630.

[50] 279 U.S. 573 (1929).

[51] See Forbes Lithograph Mfg. Co. v. White, 42 F.2d 287 (N.D. Mass. 1930).

[52] 26 B.T.A. 1210 (1932).

sold insurance policies it held on the lives of its officers for a price equal to the cash surrender value of the policies. The cash surrender value was significantly lower than the aggregate premiums paid on the policies by the corporation. The Board of Tax Appeals held that no loss resulted from the sale of the policies because the premiums paid (which exceeded the cash surrender values) represented the cost of insurance protection, which the Board observed was a non-deductible expense. The Board distinguished Lucas on the basis that Lucas involved the amount of gain realized, and not the cost of the policies themselves.[53] In disagreeing with the holding in Forbes, the Board found that Lucas had not established a rule that the total premiums paid offset a taxpayer's amount realized regardless of whether gain or loss was realized by the taxpayer. Moreover, the Board held that a life insurance contract is composed of two elements, insurance protection and cash surrender value, the former of which is not a capital asset. In the Board's view, the portion of the premiums paid for insurance protection cannot represent the cost of the asset for tax purposes.

Following Keystone, courts have traditionally denied original owners of policies the ability to recognize losses for amounts received on the sale of their life insurance policies. While not directly addressed by these cases, the tax policy underlying the denial of loss recognition based on aggregate premiums paid in these decisions may be understood as grounded in the deduction disallowance of Section 264(a)(1). Original owners of life insurance policies who are the beneficiaries under the policies have an insurable interest in the policies and, if an original owner experiences a loss on the sale of their policy, allowing the original owner a basis in their

[53] Id. at 1212.

policy equal to the aggregate premiums paid would be contrary to Section 264(a)'s denial deductions for premiums paid by an original owner.

Two years after the decision in Keystone, the Third Circuit was confronted with an almost identical situation when a corporation, which held insurance policies on its officers, sold the policies for their cash surrender values.[54] In Century Wood Preserving Co. v. Commissioner, the Third Circuit followed the reasoning of Keystone and denied the corporation a loss deduction on the excess of the premiums paid over the sales price. As in Keystone, the Third Circuit concluded that "cost [was] not the total amount paid in as premiums, since continuing insurance protection is part of the consideration for the contract." The court in Century Wood determined that the part of the premiums representing insurance protection had been earned and used.

The issue was again revisited in Summers and Moore v. Commissioner,[55] where the Board of Tax Appeals determined that "the question [at issue in Summers was] on all fours with [the Board's decision] in . . . Century Wood Preserving Co. v. Commissioner." Again, the Board determined that the losses were not deductible due to the dual nature of life insurance policies.

With the exception of Forbes, the courts agree that, for purposes of determining whether a taxpayer recognizes a loss on the surrender of a policy, the portion of premiums paid that represents the cost of insurance protection has been earned and used.[56] In London Shoe Co. v.

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[54] Century Wood Preserving Co. v. Comm'r, 69 F.2d 967 (3d Cir. 1934).

[55] B.T.A. Memo. (RIA) 1935-100.

[56] See Standard Brewing Co. v. Comm'r, 6 B.T.A. 980 (1927) (on nearly identical facts to Office Decision 724, C.B. 244 (1920) (discussed below in Part III.C.), the Board of Tax Appeals upheld the IRS's denial of a loss deduction, finding the amount of premiums representing the cost of insurance was a current and extinguished asset); London Shoe Co. v. Comm'r, 80 F.2d 230 (2d Cir. 1935) (surrender of a life insurance policy on an employee for the cash surrender value resulted in a loss, the loss was denied because the proper measure of loss was with respect to only the portion of premiums attributable to investment rather than the cost of insurance protection); Early v. Atkinson, 175 F.2d 118 (4th Cir. 1949) (same).

Commissioner,[57] the court acknowledged that the precursor to Section 72(e) allowed taxpayers to use the aggregate premiums paid to offset gain, [58] but held that the statute applied only to gains and not losses, and was therefore inapplicable. Implicitly, the court in London Shoe acknowledged that only cases addressing a loss by the original policy holder require reduction for the cost of insurance. Currently, in cases where a policy is *surrendered* rather than *sold*, Section 72(e) directs taxpayers to use the aggregate premiums paid approach for computing gains, but is silent on computing tax basis for losses.[59]

In nearly every case where an original owner of a policy sold the policy and realized a loss, courts have held insurance policies are dual-natured: part insurance protection and part cash surrender value. In Century Wood, the court stated that:

> 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 represent annual insurance protection has been earned and used. The other part of the premium is an investment built up as a reserve until the policy is matured or surrendered. If it is surrendered, the holder is entitled to the cash surrender value from the insurer, or, roughly, the return of the equivalent of his investment after the cost of annual protection is deducted from the premiums.[60]

Thus, while the cases have provided for the reduction of basis by the cost of insurance, the rationale of the case law is not readily applicable to secondary market ownership of life insurance policies and has been applied only in cases involving sales of policies for losses.

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[57] 80 F.2d 230.

[58] Revenue Act of 1928, § 22(b)(2) (income does not include "[a]mounts received . . . under a life insurance, endowment, or annuity contract, but if such amounts . . . exceed the *aggregate* premiums or consideration paid . . . then the excess shall be included in gross income.").

[59] Section 72(e). However, taxpayers are permitted a loss deduction under Section 72(b)(3) for unrecovered investment in the contract when payments on an annuity cease by reason of the death of the annuitant.

[60] Century Wood, 69 F.2d at 968.

C. IRS Analysis of Gains on the Sale of Life Insurance Policies

In Revenue Ruling 70-38,[61] a corporation sold life insurance contracts it held on its officers for the cash surrender value, which was less than the aggregate premiums paid. The ruling provides that the corporation is not required to include the sale proceeds in its gross income. Revenue Ruling 70-38 superseded Office Decision 724 ("O.D. 724").[62] In O.D. 724, the facts were the same as in Revenue Ruling 70-38 except that there was no assumption that the polices were sold at their cash surrender value. The results of Revenue Ruling 70-38 and O.D. 724 are consistent with the tax policies underlying Section 72(e). If a policy is sold, the aggregate premiums paid for the policy, unreduced by cost of insurance, is treated as the "basis" used to determine whether gain is received on the sale. In fact, Revenue Ruling 70-38 superseded O.D. 724 rather than overrule it, because the exact same position stated in O.D. 724 was set forth in the Revenue Ruling 70-38. Revenue Ruling 70-38 was intended to reestablish the view that the aggregate premiums paid under a policy are included in the "basis" used to determine gain received on a sale, without any reduction for the cost of insurance protection.

In 1994, however, the IRS issued private letter ruling 9443020.[63] In that letter ruling, a terminally ill taxpayer sold a life insurance policy to a viatical settlement company. The IRS ruled that the taxpayer's adjusted basis, for purposes of determining gain on the sale, was the total net premiums paid, reduced by the cost of insurance protection,[64] and therefore that the proceeds were taxable under Section 61.[65] The ruling cited London Shoe and Century Wood for

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[61] 1970-1 C.B. 11.

[62] C.B. 244 (1920).

[63] (July 22, 1994).

[64] This amount was approximated by subtracting the cash surrender value from the amount of premiums paid.

[65] Private letter ruling 9443020 predates the passage of Section 101(g).

the proposition that the taxpayer's basis in his policy is equal to "the premiums paid less the sum of (i) the cost of insurance protection provided through the date of sale and (ii) any amounts (e.g. dividends) received under the contract that have not been included in gross income." [66]

The IRS reiterated this position in Chief Counsel Advice 2005-04001.[67] The Counsel Advice addressed damages to be paid for fraudulent misrepresentation relating to a life insurance policy. The IRS determined the taxpayer's basis in the policy did not include the cost of insurance and that the insurance protection portion of the policy was extinguished. The Counsel Advice cited Century Wood for the position that "the cost of the policies was appropriately reflected by the cash surrender value of the policies because the surrender value is the amount of premiums reduced by the sum of the cost of the insurance protection." Notably, the Counsel Advice also cited Revenue Ruling 70-38, stating that it involved an identical fact pattern as Century Wood and indicating that, because the taxpayer in Revenue Ruling 70-38 received the cash surrender value on the sale, no gross income was received.

The conclusions set forth in private letter ruling 9443020 and Chief Counsel Advice 2005-04001 ignore the fact that Century Wood and London Shoe addressed only situations in which a taxpayer sold or surrendered its policy for a loss. If the result in private letter ruling 9443020 and Chief Counsel Advice 2005-04001 are extended into the secondary market, inequities and distortions will result. A taxpayer that surrenders a policy to the insurance company would enjoy a lower income tax liability than a taxpayer who sells its policy and is

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[66] Priv. Ltr. Rul. 9443020. In Century Wood, the court did not establish a per se rule that basis is equal to cash value, instead it held that basis must be reduced by the cost of insurance protection and that, given the taxpayer's failure of proof, basis should not exceed cash value. 69 F.2d at 968.

[67] (Oct. 12, 2004).

required to reduce its basis in the contract to reflect the amount of insurance protection. Such a situation would result vastly different tax liabilities for similarly situated taxpayers.

D. Recommendation That Secondary Market Owners of Life Insurance Policies Should Be Entitled to a Basis in the Policy Equal to the Aggregate Premiums Paid on the Policy

We recommend that the Treasury and the IRS issue guidance to the effect that a secondary market holder of a life insurance policy acquires a basis in policy equal to the sum of the purchase price and the aggregate premiums paid by the taxpayer on the policy, without reduction for amounts allocated to the cost of insurance protection.[68]

The regulations under Section 263(a) require capitalization of amounts paid to acquire an insurance contract.[69] Thus, a secondary market owner of a life insurance policy must take a basis in a policy equal to the acquisition cost of the policy. Capitalization under the Section 263(a) regulations does not require a reduction based on the cost of insurance protection. This result is consistent with the policy of both Section 72 and 101(a)(2). Under those sections, the holder of a life insurance policy is entitled to reduce its income based on the premiums paid on the policy. In the case of a surrender, Section 72(e) excludes from a policy holder's income amounts received up to the holder's investment in the contract, unreduced by the cost of insurance protection. Under Section 101(a)(2), death benefits paid to a transferee for value are excluded from the transferee's income to the extent of the transferee's cost to acquire the policy plus the

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[68] At least one commentator has taken the opposite view and suggested that Section 72 be amended to reduce basis of a policy in a surrender situation because of the possibility that similarly situated taxpayers may be treated differently and life insurance policies are based on both a cash surrender value and the cost of insurance protection. See Mitchell M. Gans and Jay A. Soled, "A New Model for Identifying Basis in Life Insurance Policies: Implementation and Deference," 7 Fla. Tax Rev. 569, 592 (2006).

[69] See Treas. Reg. §§ 1.263(a)-4(b), (c).

aggregate premiums paid by the transferee on the policy. The treatment of payments on the life insurance contract under Sections 72(e) and 101(a)(2) is consistent with the treatment that would arise if a secondary market holder of a life insurance policy acquired a basis in the policy equal to the cost to acquire the policy plus subsequent premium payments, unreduced by the cost of insurance.

Further, granting a secondary market holder basis in the policy is consistent with published IRS guidance regarding treatment of sales income resulting from the sale of a life insurance policy.[70]

Finally, allowing secondary market owners a basis in the life insurance policy does not frustrate Congressional intent under Section 264, regardless of whether the secondary market holder disposes of a policy for a gain or loss. A secondary market seller of a life insurance policy will not be a direct or indirect beneficiary under the policy. Courts have implicitly understood that an original holder of a policy that sells a policy for gain is different than a sale for a loss because there is no danger of circumventing the prohibition on deductions for insurance cost under Section 264(a). An original holder of a life insurance policy receives tax-free death benefits, but is prevented under Section 264(a) from deducting the premiums paid under the policy if he or she is a beneficiary. Conversely, the death benefits paid to a secondary market holder of a life insurance policy are taxable so there is no reason to deny the secondary market holder a basis in the policy equal to the purchase price of the policy plus the secondary market holder's aggregate premiums paid under the policy.

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[70] See Rev. Rul. 70-38, 1970-1 C.B. 11.

V. Application of Section 264(f)

A. Overview of Section 264

Section 264 generally denies interest deductions on indebtedness used (directly or indirectly) to purchase certain life insurance policies. The tax policy underlying Section 264 is generally that a taxpayer should not be entitled to current interest deductions in respect of life insurance because (i) taxpayers are not subject to current tax on the "inside buildup" of the policy (i.e., the investment and reinvestment of the premiums) and (ii) the death benefit may escape tax entirely.[71] In this respect, Section 264 is analogous to Section 265 (which denies deductions on interest and expenses allocable to tax-exempt income) and the statutory language in each section is similar.

More specifically, Section 264(a)(4) generally denies interest expense deductions in respect of any interest paid or accrued on any indebtedness with respect to one or more life insurance policies (or endowment or annuity contracts) owned by the taxpayer covering the life of any individual.

Section 264(f), in general, denies a U.S. taxpayer and its "controlled group" (i.e., 50% controlled and controlling affiliates) a deduction for the portion of their aggregate interest expense that is "allocable" to "unborrowed policy cash values" on insurance or annuities held by

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[71] See Section 101.

any members of the taxpayer's controlled group (even though the interest expense is not otherwise associated with indebtedness that relates to any life insurance policy or annuity).[72]

Pursuant to Section 264(f), a taxpayer's disallowed interest expense is equal to the taxpayer's total interest expense (including the interest expense of its 50% controlled and controlling affiliates) multiplied by the following fraction:

$$\frac{\text{the excess of (A) the cash surrender value of any insurance policy or contract held by a member of the controlled group (determined without regard to any surrender charge) over (B) the amount of any loan in respect of such policy or contract}}{\text{the sum of the unborrowed policy cash values and the average adjusted bases of all of the taxpayer's other assets}}$$[73]

B. Section 264(f)(6) Coordination Provision

Section 264(f)(6) coordinates Section 264(a) and Section 264(f). The coordination rule is intended to ensure that a taxpayer is denied an interest deduction only once (i.e., either under Section 264(a) or under Section 264(f)). The coordination rule is modeled after (and virtually identical to) Section 265(b)(6), which provides a similar coordination rule between Section 265(a) and (b).

Section 264(f)(6) provides that interest expense disallowed under Section 264(a) is not taken into account for purposes of applying Section 264(f) and that the fraction for determining

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[72] See Section 264(e)(5), (f)(6), and (f)(8). The term "unborrowed policy cash values" is defined as "the excess of (A) the cash surrender value of such policy or contract determined without regard to any surrender charge over (B) the amount of any loan in respect of such policy or contract." See Section 264(f)(3).

If the unborrowed policy cash values do not reasonably approximate the policy's actual value, then the greater of the amount of insurance company liability or the insurance company reserve with respect to such policy is used instead. See Section 264(f)(3).

[73] Section 264(f)(2).

the amount of interest expense to be denied under subsection (f) is adjusted by reducing (but not below zero) the denominator under Section 264(f)(2)(B) by the amount of indebtedness associated with the interest expense denied under Section 264(a).[74]

It would be helpful if the IRS confirmed that the numerator of the fraction is similarly reduced. The natural reading of the phrase "*loan in respect of such policy or contract*" suggests that the numerator of the fraction is intended to be reduced by any indebtedness in respect of the policy for which interest expense is denied under Section 264(a) (i.e., including indebtedness incurred or continued to purchase or carry a life insurance contract) and the reduction of the numerator is not limited to a loan under the policy (i.e., if the taxpayer borrows against the policy's cash surrender value). To the extent a taxpayer has incurred or continued indebtedness to purchase or carry a life insurance contract (even if the taxpayer did not borrow under the policy against the policy's cash surrender value), the numerator of the fraction should be reduced. If the numerator is not reduced, the taxpayer suffers a double denial of the interest expense. The following example illustrates this effect.

Example. Assume that a taxpayer borrowed \$200 to purchase life insurance policies with an aggregate cash surrender value of \$900. The taxpayer has unrelated indebtedness of \$400 (for total indebtedness of \$600), other investments with adjusted bases of \$100, and aggregate gross interest expense of \$60, \$20 of which is attributable to the \$200 borrowed to purchase the life insurance policies and \$40 of which is attributable to the taxpayer's other assets.

Assume that the \$20 of interest expense that is attributable to the policies is disallowed under Section 264(a)(4). Under Section 264(f)(6), the Section 264(f)(2) fraction would apply only to \$40 of interest expense (i.e., \$60 of aggregate interest expense less the \$20 of interest expense denied under Section 264(a)).

[74] See Section 264(f)(6)(A)(i) and (ii).

If "loan in respect of such policy or contract" in the numerator of the Section 264(f)(2) fraction does not include the $200 of indebtedness that was used to purchase the life insurance policies, the numerator would be $900 ($900 cash surrender value of the policies) and the denominator would be $1,000 ($900 cash surrender value plus $100 adjusted basis of other assets). In this case, section 264(f)(6) would reduce the denominator of the Section 264(f)(2) fraction to $800 ($1,000-$200 indebtedness associated with interest expense deduction denied under section 264(a) but, because the numerator is not reduced, the quotient of 1.13 ($900/$800) when multiplied by the $40 of interest expense would deny $45.20 of interest expense. When this disallowed interest expense is added to the $20 of interest expense already denied under Section 264(a), the aggregate interest amount allocable to life insurance policies would equal $65.20 (in excess of the total interest actually paid), and therefore the taxpayer would be denied all of its interest expense, even though some of the taxpayer's interest expense is economically allocable to $100 of non-insurance assets.

If "loan in respect of such policy or contract" includes any indebtedness in respect of the policy for which interest expense is denied under Section 264(a), the numerator of the Section 264(f)(2) fraction would be reduced by $200,[75] and the quotient of 0.875 ($700/$800) would be multiplied by the $40 of interest expense, which would deny additional interest expense of $35.00. This amount, when added to the $20 of interest expense already denied pursuant to Section 264(a), would result in a net interest expense denial of $55.00 and would permit deductible interest expense of $5.00. This is a logical result because, after excluding $200 of indebtedness and $20 of interest expense from the calculation (because these amounts were

[75] Because the numerator is equal to the excess of the cash surrender value of a contract reduced by the amount of any "loan in respect of such policy or contract", expanding the definition of "loan in respect of such policy or contract" effectively reduces the numerator.

already accounted for under Section 264(a)), the taxpayer would have \$700 of cash surrender value (i.e., \$900 cash surrender value less \$200 of debt allocable to it) and \$100 of non-insurance related assets (i.e., 1/8 of its assets are not insurance-related assets). If the \$40 of interest expense that was not accounted for under section 264(a) is multiplied by 1/8, the result is \$5.00 (i.e., the interest expense that is not allocable to life insurance assets).

Therefore, we recommend that regulations or other guidance confirm that "loan in respect of such policy or contract" includes any indebtedness in respect of the policy for which interest expense is denied under Section 264(a) so that the numerator of the Section 264(f)(2) fraction is decreased by this amount and the coordination rule effectively ensures that a taxpayer does not suffer a double disallowance of interest expense.

This interpretation is consistent with the operation of the analogous provision in Section 265. Section 265(b)(6) contains a rule that coordinates Section 265(a) with Section 265(b) and is similar to the coordination rule contained in Section 264(f)(6). The coordination rule in Section 265 unambiguously reduces both the numerator and denominator of the fraction used to calculate disallowance and, therefore, operates to reduce the amount of interest expense disallowed under Section 265(b) to account for interest expense already disallowed under Section 265(a).

C. Application of Section 264(f) to Foreign Taxpayers That Hold Insurance Policies That Are Not Effectively Connected with a U.S. Trade or Business.

As discussed above, Section 264(f) disallows a portion of a taxpayer's interest expense. Section 264(f), however, does not indicate how it applies to a foreign taxpayer that is engaged in a trade or business in the United States but whose life insurance policy is not held in connection with the U.S. business.

Section 264(f) could be applied to disallow a portion of the foreign taxpayer's effectively connected interest expense by computing the fraction based on the taxpayer's worldwide assets and liabilities and multiplying it by the taxpayer's effectively connected interest expense. Alternatively, Section 264(f) could be applied only with respect to the taxpayer's effectively connected assets and interest expense and, if the taxpayer did not own any life insurance policies that were effectively connected to its trade or business in the United States, then no interest deductions would be disallowed. We recommend this second approach.

The purpose of Section 264 is to prevent taxpayers from claiming interest deductions properly allocable to life insurance policies because tax on the inside buildup of life insurance policies is deferred and may be avoided entirely upon the death of the insured.

If a foreign taxpayer's insurance policy is not held in connection with its trade or business in the United States (i.e., income and gain with respect to it would not be effectively connected with a trade or business in the United States), then interest deductions are not properly allocable to it, and the taxpayer is not able to deduct interest expense and defer or avoid tax on the inside buildup (because gain on the policy would not be subject to U.S. federal tax in any event). In this case, it would be inappropriate to apply Section 264(f) to the taxpayer. However, when a life insurance policy is held in connection with a trade or business in the United States, interest expense that is allocable under Section 882 to income with is treated as effectively connected with the conduct of a trade or business in the United States should be subject to Section 264.