Part I

Section 101.--Certain Death Benefits.
(Also §§ 263, 865, 1001, 1011, 1012, and 1221)

Rev. Rul. 2009-14

ISSUE

What are the tax consequences to B, in the situations described below, upon the receipt of death benefits, or upon the receipt of sale proceeds, with regard to a term life insurance contract that B purchased for profit?

FACTS

Situation 1

A is a United States citizen residing in the United States. B is a United States person as defined in § 7701(a)(30) of the Internal Revenue Code (Code). B determines taxable income using the cash method of accounting and files its income tax returns on a calendar year basis.

On June 15, 2008, B purchased from A for $20,000 a "life insurance contract" (as defined in § 7702) on the life of A. The contract was originally issued by IC, a domestic corporation, to A on January 1, 2001. The contract was a level premium fifteen-year term life insurance contract without cash surrender value. At the time of purchase, the

remaining term of the contract was 7 years, 6 months, and 15 days. The monthly premium for the contract was $500, due and payable on the first day of each month. As owner of the contract, B had the right to change the beneficiary and, pursuant to that right, named itself beneficiary under the contract immediately after acquiring the contract.

B had no insurable interest in A's life and, except for the purchase of the contract, B had no relationship to A and would suffer no economic loss upon A's death. B purchased the contract with a view to profit. The contract in B's hands was not property described in § 1221(a)(1)-(8). The likelihood that B would allow the contract to lapse by failing to pay any of the remaining premiums was remote.

On December 31, 2009, A died, and IC paid $100,000 under the life insurance contract to B by reason of A's death. Through that date, B had paid monthly premiums totaling $9,000 to keep the contract in force.

Situation 2

The facts are the same as in Situation 1, except that A did not die and, on December 31, 2009, B sold the contract to C (a person unrelated to A or B) for $30,000.

Situation 3

The facts are the same as in Situation 1, except that B is a foreign corporation that is not engaged in a trade or business within the United States (including the trade or business of purchasing, or taking assignments of, life insurance contracts).

LAW AND ANALYSIS

SITUATION 1.

Amount of income recognized by B upon the receipt of death benefits

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

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

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

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

insurance contract on the complete surrender, redemption, or maturity of the contract, § 72(e)(5)(A) requires that the amount be included in gross income but only to the extent it exceeds investment in the contract. For this purpose, § 72(e)(6) defines "investment in the contract" as of any date as the aggregate amount of premiums or other consideration paid for the contract before that date, less the aggregate amount received under the contract before that date to the extent that amounts was excludable from gross income. In the case of a transferee for value, only the actual value of consideration paid for the contract, plus premiums and other consideration paid after the transfer, is taken into account. See generally § 72(g); § 1.72-10.

Section 101(a)(1) provides, generally, that gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured. In the case of a transfer for valuable consideration, however, § 101(a)(2) provides that the amount excluded from gross income shall not exceed an amount equal to the sum of the actual value of the consideration paid and the premiums and other amounts subsequently paid by the transferee. The "transfer for value" rule of § 101(a)(2) does not apply in the case of a transfer involving a carryover basis or in the case of a transfer to the insured, a partner of the insured, a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

In Situation 1, B received $100,000 from IC by reason of the death of A, the insured under the contract. Because B purchased the contract from A in exchange for a purchase price of $20,000, B's acquisition of the contract was a "transfer for a valuable

consideration" within the meaning of § 101(a)(2). Neither the carryover basis exception of § 101(a)(2)(A) nor the exception for transfers involving parties related to the insured under § 101(a)(2)(B) applied. Accordingly, § 101(a)(1) excludes from B's gross income the amount received by reason of A's death, but § 101(a)(2) limits the exclusion to the sum of the actual value of the consideration paid for the transfer ($20,000) and other amounts paid by B ($9,000), or $29,000. B therefore must include in gross income $71,000, which is the difference between the total death benefit received ($100,000) and the amount excluded under § 101 ($29,000).

Character of income recognized by B upon the receipt of death benefits

Neither § 61(a) nor § 72(e) specifies whether taxable amounts of death benefits received by a transferee for value of a life insurance contract by reason of the death of the insured are treated as ordinary income or as capital gain. Thus, the character of the income that B recognized upon receipt of death benefits under the contract is capital gain only if it so qualifies under the general rules of subchapter P (§§ 1201-1260).

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

Neither the surrender of a life insurance or annuity contract nor the receipt of a death benefit from the issuer under the terms of the contract produces a capital gain. Accordingly, the $71,000 income recognized by B upon the receipt of death benefits under the contract is ordinary income.

SITUATION 2.

Amount of income recognized by B upon sale of life insurance contract

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

Pursuant to § 1001(b), B's amount realized from the sale of the life insurance contract is the sum of money received from the sale, or $30,000.

Under §§ 1011 and 1012, the adjusted basis for determining gain or loss is generally the cost of the property as adjusted provided in § 1016, except as otherwise provided in subchapters O (§§ 1011 through 1092), C (§§ 301 through 386), K (§§ 702 through 777), and P (§§ 1201 through 1298). Section 101(a)(2) has no bearing on the determination of the basis of a life insurance contract that is sold, because § 101(a)(2) applies only to amounts received by reason of the death of the insured.

The starting point for determining the basis of a life insurance contract for purposes of measuring gain on its sale is its cost. Section 1.263(a)-4(c)(1)(iv) requires taxpayers to capitalize an amount paid to another party to acquire an intangible

(including a life insurance contract) from that party in a purchase or similar transaction. In Situation 2, B paid $20,000 to A to acquire the life insurance contract from A, which is included in B's cost basis.

In Situation 2, B also paid $9,000 in monthly premiums to prevent the contract from lapsing. No deduction is allowed for these monthly premiums under section 264. However, § 1.263(a)-4(b)(1)(iv) 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 premiums paid by a secondary market purchaser of a term life insurance contract serve to create or enhance a future benefit for which capitalization is appropriate. Accordingly, this revenue ruling requires a secondary market purchaser to capitalize premiums paid to prevent a term life insurance contract (without cash value) from lapsing. The Service will not challenge the capitalization of such premiums paid or incurred prior to the issuance of this ruling.

In Situation 2, B paid $20,000 to acquire the life insurance contract and $9,000 in monthly premiums to prevent the contract from lapsing. Therefore, B's adjusted basis for purposes of measuring gain on the sale to C was $29,000.

In Rev. Rul. 2009-13, page ___ , this Bulletin, Situation 2, a taxpayer paid premiums totaling $64,000 with regard to a life insurance contract, and $10,000 of "cost of insurance" charges were subtracted from the contract's cash surrender value. The taxpayer sold the contract for $80,000. The ruling concludes that the taxpayer's gain on the sale was equal to $26,000, representing the $80,000 amount realized less $54,000 adjusted basis ($64,000 total premiums paid minus $10,000 cost of insurance charges).

The ruling notes that on these facts, the reduction for cost of insurance charges is necessary to account for the insurance protection the taxpayer received before the sale. Similarly, in Century Wood Preserving Co. v. Commissioner, 69 F.2d 967 (3rd Cir. 1934), the court concluded that a taxpayer who sold a life insurance contract could not include in basis amounts that were used to provide annual insurance protection. See also London Shoe Co. v. Commissioner, 80 F.2d 230 (2d Cir. 1935); Keystone Consolidated Publishing Co. v. Commissioner, 26 B.T.A. 1210 (1932).

B is not required to reduce its basis in the life insurance contract by any cost of insurance charges that may have been imposed. In Rev. Rul. 2009-13, Century Wood Preserving, London Shoe, and Keystone Consolidated, adjusted basis was reduced by cost of insurance charges because those charges represented the cost of insurance protection that was enjoyed by the policyholder as the beneficiary of the policy. In contrast, in Situation 2 B is wholly unrelated to A and did not purchase the life insurance contract for protection against any economic loss upon A's death. B acquired and held the contract solely with a view to profit, and paid additional premiums to prevent the lapse of B's purely financial investment, the contract. Situation 2 is thus distinguishable from Rev. Rul. 2009-13 and the authorities cited therein.

As the amount realized on B's sale of the life insurance contract to C was $30,000, and the adjusted basis was $29,000, B must recognize $1,000 on the sale to C in Situation 2.

Character of income recognized by B upon sale of life insurance contract

Because the term life insurance contract was not property described in § 1221(a)(1)-(8) and was held for more than one year, the $1,000 of gain recognized by B under § 1001 upon the sale of the contract to C is long-term capital gain. Rev. Rul. 2009-13. Additionally, the contract was a term contract without any cash value. Hence, the substitute for ordinary income doctrine under United States v. Midland Ross, 381 U.S. 54 (1965), and its progeny does not apply.

SITUATION 3

Amount and characterization of income recognized by B upon the receipt of death benefits

As in Situation 1, B must recognize $71,000 of income upon the receipt of death benefits. This income is "fixed or determinable annual or periodical" income within the meaning of § 881(a)(1). See § 1.1441-2(b); Rev. Rul. 64-51, 1964-1 C.B. 322; Rev. Rul. 2004-75, 2004-1 C.B. 516. Consequently, B is subject to tax under § 881(a) with respect to this income, if the income is from sources within the United States.

Source of income recognized by B upon the receipt of death benefits

Section 861(a)(1) provides that interest received from a domestic corporation is generally from sources within the United States.

Section 861(a)(7) provides that premiums received from the issuance of any life insurance contract are generally income from sources within the United States when the premiums are derived in connection with a life insurance contract issued in respect of the lives of residents of the United States.

Section 865 provides that the source of income from the sale of personal property is generally determined by reference to the residence of the taxpayer.

When the source of an item of income is not specified by statute or by regulation, courts have determined the source of the item by comparison and analogy to classes of income specified within the statute. See 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). See also Rev. Rul. 79-388, 1979-2 C.B. 270.

The Code does not specify the source of income resulting from the payment of death benefits pursuant to a term life insurance contract. See also Rev. Rul. 2004-75. Consequently, the source of such income is determined by comparison and analogy to classes of income that are specified within the statute.

In the current situation, A is a United States citizen residing in the United States, and IC is a domestic corporation. B's income is from sources within the United States.

HOLDINGS

1. In Situation 1, B must recognize $71,000 of ordinary income on the receipt of death benefits with respect to the life insurance contract.

2. In Situation 2, B must recognize $1,000 of long-term capital gain on the sale of the life insurance contract.

3. In Situation 3, B must recognize $71,000 of ordinary income from sources within the United States, and tax is imposed under § 881(a)(1) with respect to this amount.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Josephine H. Firehock of the Office of Associate Chief Counsel (International) and Stephen D. Hooe of the Office of Associate Chief Counsel (Financial Institutions and Products). For further information regarding this ruling, contact Stephen D. Hooe at (202) 622-3970 (not a toll-free call). For questions relating to section 263(a), contact the Office of Associate Chief Counsel (Income Tax & Accounting) at (202) 622-4800. For questions relating to section 861 or 881, contact Josephine H. Firehock at (202) 622-4233.