

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

September 27, 2004

Third Party Communication: None
Date of Communication: Not Applicable

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CASE-MIS No.: TAM-131029-04

Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No

Years Involved:

Date of Conference:

LEGEND:

Taxpayer =

State A =

Product 1 =

Product 2 =

Date 1 =

\$a =

Company 1 =

Amount 1 =

\$b =

Amount 2 =

Date 2 =

Amount 3 =

Date 3 =

Company 2 =

Date 4 =

Date 5 =

Date 6 =

Amount 4 =

\$c =

\$d =

\$e =

a% =

\$f =

ISSUE(S):

To what extent does § 1234A of the Internal Revenue Code apply to amounts received by a taxpayer upon its surrender or termination of whole life insurance contracts?

CONCLUSION(S):

Section 1234A does not apply to amounts received by a taxpayer upon the termination or surrender of whole life insurance contracts to the extent the amounts are attributable to ordinary income accretions to the contracts' value.

FACTS:

Description of Taxpayer's Business Operations:

Taxpayer, a corporation headquartered in State A, is a distributor of Product 1 and a producer of Product 2. Taxpayer also offers other services related to Product 1 and Product 2. Taxpayer is the parent corporation of an affiliated group that files a consolidated federal income tax return. Taxpayer uses the calendar year as its taxable year and an accrual method as its overall method of accounting.

Facts Relating to the Transaction at Issue:

On Date 1, Taxpayer purchased from Company 1 contracts that provided approximately \$a in aggregate face value of life insurance on the lives of Amount 1 of its employees (the Company 1 Contracts). Taxpayer purchased contracts that provided an additional \$b in aggregate face value of life insurance on Amount 2 of its employees on Date 2, and on Amount 3 of its employees on Date 3, from Company 2 (the Company 2 Contracts, together with the Company 1 Contracts, the Contracts). The Contracts were individual whole life fixed premium contracts. The Contracts qualified as life insurance policies under state law, met all requirements of § 7702, and were not endowment contracts under § 7702A. Taxpayer was both the owner and the beneficiary of the Contracts and Taxpayer received tax-free death benefits under the contracts upon the death of a covered employee pursuant to § 101(a).

As whole life, rather than term, contracts, the Contracts contained both an "insurance" feature (the death benefits) and an "investment" feature. Under the terms of the Contracts and in accordance with state law, the insurance carriers credited earnings to the cash values of the Contracts. The cash values generally were credited at a rate equal to the greater of: (a) a minimum rate specified in the contract; or (b) a rate declared by the carrier based on the carrier's investment returns. The portion of the cash value of the Contracts that secured loans under the Contracts was credited with earnings equal to the greatest of: (a) a minimum rate specified in the contract; (b) a rate declared by the carrier based on the carrier's investment returns; or (c) the loan interest rate minus one percentage point.

Under the terms of the Contracts, Taxpayer was permitted to borrow from the carriers with the Contracts serving as security. Taxpayer borrowed from the carriers and deducted the interest paid on its tax returns for the taxable years ending Date 4 through Date 5. The Internal Revenue Service (IRS) proposed to disallow the interest deductions, and on Date 6 Taxpayer and the IRS entered into a closing agreement to resolve their dispute (the Closing Agreement).

At any time before the death of an insured employee, and in lieu of receiving the death benefit, Taxpayer could terminate a contract and receive an amount equal to the cash value by surrendering the contract. On Date 6, Taxpayer terminated Amount 4 of the Company 1 Contracts and all of the Company 2 Contracts. In return, Taxpayer received \$c, of which \$d was received in cash and \$e was applied to satisfy Taxpayer's obligations on the loans secured by the Contracts and the accrued interest thereon. The IRS and Taxpayer specified in the Closing Agreement that only a% of the amount (\$f) "otherwise includible in gross income under § 72 of the Internal Revenue Code" as a result of the termination and surrender of the Contracts was includible in Taxpayer's gross income. However, the Closing Agreement did not specify the character of the amounts to be included in income by Taxpayer.

LAW AND ANALYSIS:

Section 1234A(1) provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation (other than a securities future contract described in § 1234B) with respect to *property which is (or on acquisition would be) a capital asset* in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset. (Italics added).

Section 1221 defines "capital asset" to mean "property held by a taxpayer (whether or not connected with his trade or business)," with the exception of the items described in §§ 1221(a)(1)-(8). However, the Supreme Court has held that not everything that can be called "property" in the ordinary sense and that is outside the statutory exclusions in § 1221 qualifies as a capital asset under § 1221, or for purposes of § 1231, and that the term does not include certain claims or rights to ordinary income. See *Commissioner v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 134-136 (1960), Ct. D. 1853, 1960-2 C.B. 466.

Although a whole life insurance contract is not described in any of the exceptions set forth in §§ 1221(a)(1) - (8), the Supreme Court has stated that, "this Court has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income." *United States v. Midland-Ross Corp.*, 381 U.S. 54, 57 (1965). Subsequently, in *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 217, n5 (1988), the Supreme Court specifically noted the definition of "§ 1221 property" excludes income items or accretions to the value of a capital asset properly attributable to ordinary income.

Accordingly, to the extent amounts received by Taxpayer upon the surrender of the Contracts are attributable to ordinary income accretions to the Contracts' value, the ordinary accretion component of the payment amount does not constitute "property that is a capital asset" and § 1234A does not apply.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.