**The Baseless Basis**

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***Article for the Tax Facts***

Generally, the two options for disposing of a life insurance contract are to surrender it or sell it. Either way, consideration must be given to determining whether there is a gain on the contract for income tax purposes. That calculation requires figuring the difference between what the policy holder received and what they are deemed to have given for the contract. In the latter regard, what is considered to have been given depends upon whether the transaction is a surrender governed by IRC § 72 or a sale covered by § 1001.

In the case of surrenders, § 72(e)(6) states that the amount given is the “investment in the contract” and that is comprised of the aggregate amount of premiums or other consideration paid, minus the total amount previously received under the contract that was excluded from gross income. Here it should be noted that premiums paid are only those submitted for the basic contract and do not include amounts paid for supplementary benefits such as disability income, accidental death benefits or waiver of premium. Further, any premiums that are made up under a waiver of premium provision are excluded from the aggregate of premiums paid. On the other hand, the most common nontaxable distributions that reduce a policy holder’s investment in the contract are dividends, withdrawals and policy loans.

Turning to the sale of a policy the amount given pursuant to § 1011 is the “adjusted basis” which is comprised of the cost of the policy as modified for “expenditures, receipts losses or other items properly chargeable…” In determining what is properly chargeable the IRS has stated in Rev. Rul. 2009-13 that since a life policy may have both investment characteristics and insurance characteristics it is necessary to reduce the adjusted basis of the contract by the “cost of insurance” before the sale of the policy.[[1]](#footnote-1) This approach results in a reduction of adjusted basis and a greater potential for taxable gain on the sale of a policy. The problem is that the Service’s reasoning in Rev. Rul. 2009-13 represents an inconsistent interpretation of existing case law and its own regulations.[[2]](#footnote-2) Worse yet, while requiring that the cost of insurance must be deducted from adjusted basis the Service does not offer a safe harbor method for

determining what the cost of insurance is for a policy that is being sold. The practical solution for a policyholder is to contact the issuing company and ask for the cost of insurance on the contract. Alternatively, some companies illustrations contain schedules of the cost of insurance on their policies.

1. Rev. Rul. 2009-13, 2009-21 IRB 1029, 05/01/2009 [↑](#footnote-ref-1)
2. LSI Estate Planning Newsletter #1493 (July 23, 2009) at http://www.leimbergservices.com [↑](#footnote-ref-2)