TaxNewsFlash

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Rev. Rul. 2020-05: Adjustments to basis for life insurance contracts

The IRS today released an advance version of Rev. Rul. 2020-05 that updates guidance previously provided in Rev. Rul. 2009-13 and Rev. Rul. 2009-14 with respect to adjustments to basis for life insurance contracts to account for the changes to section 1016(a), as amended by the U.S. 2017 tax law (Pub. L. No. 115-97)—the law that is often referred to as the "Tax Cuts and Jobs Act" (TCJA) and enacted December 22, 2017.

Read **Rev. Rul. 2020-05** [PDF 47 KB]

Background

Sections 1011 and 1012 of the Code generally provide that the adjusted basis for determining gain or loss is the cost of property as calculated based on rules contained in section 1016, which requires that proper adjustments must be made for expenditures, receipts, losses or other items properly chargeable to capital account.

A provision of the TCJA (Act section 13521) amended section 1016 by adding section 1016(a)(1)(B), which provides that in determining the basis of a life insurance contract or an annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract. This amendment is effective for transactions entered into after August 25, 2009.

Prior to amendment by the TCJA, Rev. Rul. 2009-13 and Rev. Rul. 2009-14 provided guidance on how to determine the adjusted basis of life insurance contracts under section 1011 and 1012 in several factual situations:

- In Situation 2 of Rev. Rul. 2009-13, A, an individual, entered into a life insurance contract with cash value on January 1 of Year 1. Under the contract, A was the insured, and the named beneficiary was a member of A's family. On June 15 of Year 8, A sold the contract to B, an unrelated person who would suffer no economic loss upon A's death, for $80,000. Prior to the sale of the contract, A had paid $64,000 in premiums. The cost of insurance charges collected by the issuer was $10,000 as of the date of the sale. Rev. Rul. 2009-13 provides that if a taxpayer holds a life insurance contract for purposes of insurance protection, the taxpayer must reduce its basis in the contract by that portion of the premium paid for the contract that was expended for the provision of insurance before the sale to measure the taxpayer's gain upon the sale of the contract. Therefore, Situation 2 provides that A must reduce A's basis in the contract by the cost of insurance. As a result, A's adjusted basis as of the date of the sale was $54,000 ($64,000 premiums paid less $10,000 expended as cost of insurance). Because A sold the contract for $80,000, A must recognize $26,000 of income on the sale of the contract ($80,000 amount realized less $54,000 adjusted basis of the contract).

- In Situation 3 of Rev. Rul. 2009-13, the contract was a level premium 15-year term life insurance contract without cash surrender value. The monthly premium for the term life insurance contract was $500, A held the contract for 89.5 months, and A paid premiums totaling $45,000 as of the date of the sale. A sold the contract for $20,000 to B, an unrelated person who would suffer no economic loss upon A's death. Under Situation 3, A must reduce A's basis in the contract by the cost of insurance, which is presumed to equal the monthly premiums under the contract. A's adjusted basis in the contract as of the date of the sale was therefore $250 ($45,000 total premiums paid less $44,750 cost of insurance protection). Because A sold the contract for $20,000, A must recognize $19,750 of income on the sale of the term life insurance contract ($20,000 amount realized on the sale less $250 adjusted basis of the contract).

- In Situation 2 of Rev. Rul. 2009-14, the facts are the same as in Situation 3 of Rev. Rul. 2009-13, except that B purchased the contract for $20,000 from A and then, at the end of the following year, sold the contract to C, a person unrelated to either A or B, for $30,000. Before selling the contract, B paid a total of $9,000 in premiums. In Situation 2 of Rev. Rul. 2019-14, B—unlike A in Situation 3 of Rev. Rul. 2009-13—was not required to reduce B's basis by the cost of insurance because B was wholly unrelated to the insured, did not purchase the life insurance contract for protection against economic loss upon the insured's death, purchased the contract solely with a view to profit, and enjoyed no insurance protection from the contract. B's cost basis was $29,000, the sum of what B paid for the contract and the premiums B paid to keep the contract in force ($20,000 purchase price plus $9,000 in premiums). B's adjusted basis was $29,000 ($29,000 cost basis with no adjustment for cost of insurance), and B recognized $1,000 of income on the sale of the contract to C ($30,000 amount realized on sale less $29,000 adjusted basis of the contract).

Rev. Rul. 2020-05

Because, subsequent to the TCJA, section 1016(a)(1)(B) does not reduce the cost basis of a life insurance contract for the cost of insurance, the situations in Rev. Rul. 2009-13 and Rev. Rul. 2009-14 (described above) are inconsistent with section 1016(a)(1)(B). Rev. Rul. 2020-05 modifies the above situations as follows:

- In Situation 2 of Rev. Rul. 2009-13, A's adjusted basis in the contract equals the premiums paid. A must recognize $16,000 of income on the sale of the contract ($80,000 amount realized on sale less $64,000 adjusted basis).

- In Situation 3 of Rev. Rul. 2009-13, A's adjusted basis in the contract equals the premiums paid. A will recognize a $25,000 loss on the sale of the contract ($20,000 amount realized on the sale less $45,000 adjusted basis). A will not be permitted to deduct the loss unless the loss is incurred under section 165(c)(1) or (2).

- In Situation 2 of Rev. Rul. 2009-14, B is not required to reduce B's basis in the contract by the cost of insurance because B was wholly unrelated to the insured, did not purchase the life insurance contract for protection against economic loss upon the insured's death, purchased the contract solely with a view to profit, and enjoyed no insurance protection from the contract. Under section 1016(a)(1)(B), as added by the TCJA, B is not required to reduce B's basis in the contract by the cost of insurance, regardless of why the insurance contract is purchased. Accordingly, the outcome for B in Situation 2 of Rev. Rul. 2009-14 does not change, but B's situation is no longer distinguishable from that of A in Situation 3 of Rev. Rul. 2009-13 with regards to the treatment of cost of insurance charges.

KPMG observation

Rev. Rul. 2020-05 provides useful clarifications to Rev. Rul. 2009-13 and Rev. Rul. 2009-14 in light of the TCJA amendment to section 1016(a). Taxpayers will now have clearer examples as to how to apply section 1016(a) to calculate bases of life insurance contracts.

Rev. Rul. 2009-13's requirement to reduce basis by the cost of insurance was a highly controversial decision. The insurance industry for many years sought to change the IRS's position, and the TCJA amendment to section 1016(a) represents the codification of what many have been saying for years. Rev. Rul. 2020-05 represents the IRS's implementation of this change.

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