

# Ch. 3: Gross Income

**CARS**  
car allowance rebate system

DEALER LOCATOR CARS FAQ OFFICIAL INFORMATION MP

## Successful CARS Program

The enormously successful CARS program helped consumers who turned in gas guzzlers buy nearly 700,000 more fuel efficient vehicles in fewer than 30 days. By late September the U.S. Department of Transportation paid all eligible and complete dealer transactions. "There can be no doubt that this program drummed up more business, for more people, in more places at a time when our economy needed help the most," said Transportation Secretary Ray LaHood. DOT continues to work with the few remaining dealers who have outstanding submissions to try and correct any errors so payment can be made.

### "Cash for Clunkers"

Previous Headlines

**3-1** Important Things to Know

OFFICIAL GOVERNMENT  
U.S. Department of Transportation  
National Highway Traffic Safety Administration  
HOTLINE: (405)-954-3700  
TTY: (800)-424-9153  
HOURS OF OPERATION  
MON - FRI: 8A - 10P  
SAT: 10A - 8P  
MEDIA INQUIRIES ONLY:  
REPORT  
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car allowance rebate system

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**CCA 200908025**  
State Energy Rebates May be Excludible from Income

**Not automatic!!**

**IRC sec. 136:**

- public utility subsidy
- electric, gas
- dwelling unit

**3-2**

***CCA 200908025***

State Energy Rebates May be Excludible from Income

**California is more generous**

**RTC sec. 17138.1 / 24308.1:**

- thermal, solar, wind
- any building

**RTC sec. 17138:**

- water conservation

**3-3**

***Rev. Rul. 2009-19***

**HAMP Payments Excluded from Income**

**Homeowner Affordability & Stability Plan**



**Home Affordable Modification Program**

**\$1,000/yr for 5 years**

**3-3**

***ILM 200943028***

**ARC Loan Interest Subsidy  
Excluded from Income**

**Interest-Free ARC Loan  
not Subject to  
sec. 7872**

**3-4**

**USDA:  
Forest Health  
Protection  
Program**

**3-4**

## ***Rev. Rul. 2009-23***

### **Forest Health Protection Program**

**Excludible under  
IRC sec. 126**

***Note: Sec. 126 exclusion  
is subject to limitations***

**3-4**

## ***Prop. Reg. §1.104-1(c)***

### **Personal Injury Damages**

**You don't always need a  
tort claim, but the big  
question remains:**

***What is the boundary  
for physical injuries?***

**3-5**

## ***PLR 200930029***

### **Tool Reimbursement Plans**

**IRs says this one works,  
but it's not the kind being  
sold on the street . . .**

**3-6**

## ***Notice 2009-46***

### **Employer-Provided Cell Phones**

- **Employee has own phone**
- **De minimis personal use**
- **Deemed 25% personal use**
- **Statistical sampling**

**3-8**

***Rice v. Comm'r.***

**Capital Gain  
for  
Sale of  
Subdivided Lots**

**3-8**

***Rice v. Comm'r.***

**Capital Gain for Sale of Subdivided Lots**

- **1 lot in 2000**
- **3 lots in 2004**
- **1 lot in 2005**
- **1 lot in 2007**
- **1 lot in 2008**

**3-8**

***Sec. 1237?***

- **1 lot in 2000**
- **3 lots in 2004**
- **1 lot in 2005**
- **1 lot in 2007**
- **1 lot in 2008**

**3-8**

***Freda v. Comm'r.***

**No Capital Gain  
for  
Legal Settlement**

**3-12**

**Sec. 1234A:**

**“gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation . . . with respect to property which is . . . a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset.”**

**3-13**

## Life Insurance Settlement Market

- **\$12 Billion in 2007**
- **11.5% annual growth predicted**
- **\$31 Billion Expected by 2017**

### **Rev. Rul. 2009-13 (05/01/2009)**

### **Life Insurance Surrender or Sale by Insured**

### Situation 1 – Surrender of Life Insurance Policy

**\$78,000 in cash surrender value.**

**\$64,000 cumulative premiums paid.  
(Section 72(e)(6) “investment in the  
contract”).**

**\$10,000 of “cost of insurance”.**

### Rev Rul 2009-13 Situation 1 -- Surrender of Life Insurance Contract With Cash Value:

14

<b>Cash Surrender Value</b>	<b>\$78,000</b>
<b>- Investment in the Contract</b>	<b>-\$64,000</b>
<b>= Ordinary Income on Surrender</b>	<b>\$14,000</b>

**Authority:** Although the insurance contract is a capital asset, Rev. Rul. 64-51 provides that proceeds received by the insured is ordinary income. Case law also supports this approach (Barr, TC Memo 2009-250). Rev. Rul. 2009-13 states that "Section 1234A, originally enacted in 1981, does not change this result."

## Situation 2 – Sale of Life Insurance Policy To 3<sup>rd</sup> Party

15

**\$80,000 sales price.**

**\$78,000 in cash surrender value.**

**\$64,000 cumulative premiums paid.**

**\$10,000 of "cost of insurance."**

## Rev Rul 2009-13 Situation 2 -- Sale

15

Amount Realized	\$80,000
- Adjusted Basis (\$64,000 - \$10,000)	-\$54,000
= Gain Realized and Recognized	\$26,000
Character of \$26,000 Gain:	
Ordinary Income (Substitute For OI Doc.)	\$14,000
Long-Term Capital Gain	\$12,000

**Authority:** Sections 1011, 1012, and 1016 (**not Section 72**) apply to determine the tax consequences. IRS cites case law (**v. Code**) to bifurcate the sale of the policy into elements that resulted in both ordinary income ("substitute for ordinary income doctrine") and capital gain.

## Rev Rul 55-747 – P.S. 58 Costs

Table 38

Age	Premium	Age	Premium	Age	Premium
15	\$1.27	35	\$3.21	55	\$13.74
16	1.38	36	3.41	56	14.91
17	1.48	37	3.63	57	16.18

## Notice 2002-8

"...taxpayers may use the premium rate table [below] to determine the value of current life insurance protection on a single life that is provided under a split-dollar life insurance arrangement, in a qualified retirement plan, or under employee annuity contracts."

TABLE 2001  
INTERIM TABLE OF ONE-YEAR TERM PREMIUMS  
FOR \$ 1,000 OF LIFE INSURANCE PROTECTION

Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates	Attained Age	Section 79 Extended and Interpolated Annual Rates
0	\$0.70	35	\$ 0.99	70	\$ 20.62
1	\$0.41	36	\$ 1.01	71	\$ 22.72
2	\$0.27	37	\$ 1.04	72	\$ 25.07
3	\$0.19	38	\$ 1.06	73	\$ 27.57
		55	\$ 4.15		

**Situation 3 – Sale of of Term Life Insurance To 3<sup>rd</sup> Party**

17

- \$20,000 sales price.
- No cash surrender value.
- \$45,000 cumulative total of monthly premiums.
- \$250 basis in insurance policy was 1/2 of the \$500 monthly premium that was unexpired on the sale date.

**Rev Rul 2009-13 Situation 3 Sale of Term Life Insurance Policy:**

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Amount Realized	\$20,000
- Adjusted Basis (\$45,000 – 44,750 (\$500 x 89.5 Mos.))	-\$250
= Gain Realized and Recognized	\$19,750
Character of \$19,750 Gain:	
Ordinary Income (Substitute For OI Doc.)	\$0
Long-Term Capital Gain	\$19,750

**Authority:** Because the insurance contract, a capital asset, had been held for more than one year, the \$19,750 of income would be treated as long-term capital gain.

**Rev. Rul. 2009-13 Effective Date:**

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“Under the authority of § 7805(b)(8), the holdings of this revenue ruling with respect to **Situations 2 and 3** will not be applied adversely to sales occurring before August 26, 2009.”

**Loss On Surrender**

**PLR 200945032**

**Rev. Rul 2009-13: Situation 1 –  
Surrender at a Gain**

**\$78,000 in cash surrender value.**

**\$64,000 cumulative premiums paid.  
(Section 72(e)(6) “investment in the  
contract”).**

**\$10,000 of "cost of insurance".**

**Rev Rul 2009-13 Situation 1 -- Surrender of  
Life Insurance Contract With Cash Value:**

14

<b>Cash Surrender Value</b>	<b>\$78,000</b>
<b>- Investment in the Contract</b>	<b>-\$64,000</b>
<b>= Ordinary Income on Surrender</b>	<b>\$14,000</b>

**PLR 200945032 – Sec. 72 is Inapplicable**

**“It is clear that neither the section 72 nor the underlying regulations address the situation of whether there is a loss on the complete surrender of a life insurance policy and if there is a loss, what is the amount of the loss.”**

**PLR 200945032 – Loss OK**

**“Section 264 prevents the current deduction of premiums otherwise allowable as a deduction under sections 162 and 212. Section 1.263(a)-4(d)(2) provides that a life insurance policy is a financial interest that must be capitalized. Accordingly, section 264 does not prevent the recognition of a loss when a life insurance policy is surrendered by a policyholder.”**

## PLR 200945032 – Loss Basis

The tax basis of the policies under sections 1011 and 1012 and caselaw “shall equal the sum of”:

- the premium payments,
- + the mortality credits,
- the cost of insurance,
- the mortality and expense deduction (net of mortality experience credits)

## Loss on Surrender for \$34,000

Cash Surrender Value	\$34,000
- Invest. in the Contract minus COI (\$64,000 – 10,000)	-\$54,000
= Loss on Surrender	<\$20,000>

*Sec. 165(c)(2) loss—misc. itemized deduction subject to 2% cut and not allowed for AMT (unless a sale loss Sec. 1234A).*

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**Rev. Rul. 2009-14 (05/01/2009)**

**Term Life Insurance Transactions  
Involving a Buyer**

### Situation 1

18

- The purchaser of a term life policy from an insured receives a death benefit on the insured's death.
- \$20,000 purchase price in purchase from the insured.
- \$9,000 paid by the purchaser for post-purchase premiums.
- Insurance company paid \$100,000 to the purchaser by reason of the insured's death.

**Rev Rul 2009-14 Situation 1 -- Term Life Insurance Proceeds Paid to Buyer:**

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Life Insurance Proceeds Pd. On A's Death	\$100,000
- Sec. 101(a)(2) Excl.: (\$20,000 + \$9,000)	-\$29,000
= Ordinary Income	\$71,000

**Authority:** The IRS applied the transfer-for-value rule of Section 101(a)(2) to conclude that the purchaser of the policy could not exclude the entire death benefit. Regarding the character of the income, IRS merely declares that "[n]either 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."

**Situation 2 – A Second Sale**

- The first purchaser of a term life policy sells to a second buyer for \$30,000.
- \$20,000 purchase price in first purchase from the insured.
- \$9,000 paid by the first purchaser for post-purchase premiums.

**Rev Rul 2009-14 Situation 2 -- Term Life Insurance Contract Sold By First Buyer:**

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Amount Realized	\$30,000
- Adjusted Basis (\$20,000 + 9,000)	-\$29,000
= Gain Realized and Recognized	\$1,000
<b>Character of \$1,000 Gain:</b>	
Ordinary Income (Substitute For OI Doc.)	\$0
Long-Term Capital Gain	\$1,000

**Authority:** Because the insured was not the seller, the basis was not reduced by any "cost of insurance" charges. All capital gain (sale of a capital asset); the "substitute for ordinary income" doctrine is inapplicable to term insurance.

**Situation 3 (Situation 1 Modified)**

- The purchaser of a term life policy from an insured receives a death benefit on the insured's death.
- The purchaser is a foreign corporation not engaged in a U.S. trade or business.
- \$20,000 purchase price in purchase from the insured.
- \$9,000 paid by the purchaser for post-purchase premiums.
- Insurance company paid \$100,000 to the purchaser by reason of the insured's death.

Rev Rul 2009-14 Situation 3 --  
Buyer is a Foreign Corporation

Life Insurance Proceeds Pd. On A's Death	\$100,000
- Sec. 101(a)(2) Exclusion: (\$20,000 + \$9,000)	-\$29,000
= U.S. Source Ordinary Income (FDAP--30%)	<u>\$71,000</u>

**Key Point:** The IRS clarified that the source of the insurance proceeds was U.S. source because both the insured and the insurance company were in the U.S. Also, the insurance proceeds are FDAP subject to 30% withholding.

**McGowen v. Comm'r**

**T.C. Memo. 2009-285  
December 14, 2009**

**McGowen Facts**

**\$ 500,000 Single Premium Life  
Insurance--1986**

**\$1,065,224 Gross Cash Surrender  
Value—2004**

**\$0 Net Cash Surrender  
Value—2004**

**McGowen Debt**

**\$1,065,224 Debt on Policy**

**\$ 536,500 Used for Personal Expenses**

**\$ 528,724 Accrued Interest**

**McGowen Form 1099-R Gain**

**\$1, 065,224 Cash Surrender Value**

**- \$ 500,000 Investment in Contract**

**= \$ 565,224 Gain**

**No Sec. 108 Exclusion Available**

**“The record here indicates that the loans to Mrs. McGowen were not discharged: they were extinguished after the insurer had applied the cash value of the insurance policy towards the debt owed by Mrs. McGowen.”**

**Citing Atwood (T.C. Memo. 1999-61)**

**This satisfaction of the loans had the effect of a pro tanto payment of the policy proceeds to [Mrs. McGowen] and constituted income to [her] at that time. \* \* \***

**Barr, TC Memo 2009-250 (11/30/09)**

**Same pattern as McGowen except the debt was used exclusively to pay insurance premiums.**

**Same outcome as McGowen but Barr, an attorney, was also hit with the negligence penalty.**

**Barr, TC Memo 2009-250 (11/30/09)**

**\$361,353** cash surrender value  
**354,399** total debt on policy

**\$200,000** Paid on Death of Insured

**Warning From Insurance Company**

On October 10, 2005, Barr was warned that the policy was in “overloan”:

“Should you allow the Policy to terminate through failure to pay the overloan amount, [the insurance company] is required by Federal law to report any taxable gain to the Internal Revenue Service.”

**Barr, TC Memo 2009-250 (11/3/09)**

Barr surrendered the policy and received \$11,648 on surrender of policy:

**\$361,353** cash surrender value  
**+ 4,694** terminal dividend  
**- \$354,399** repayment of loan  
**= \$11,648** Distribution to Barr

**Barr, TC Memo 2009-250 (11/3/09)**

**\$361,353** Actual and Constructive Distribution  
**- \$225,390** Net Investment in Contract  
**= \$135,963** Taxable Gain\*

\* Reported by MetLife to the IRS on Form 1099-R.

## **Barr Footnote 7**

**“Petitioners do not argue and we do not decide whether sec. 1234A applies to these facts.”**

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***FISHER v. U.S.*  
(Fed. Cir. 10/09/2009)**

**Sustained on Appeal  
In 2009**

### **Key Facts in Fisher**

**Under the demutalization plan, "the policyholders would retain their insurance coverage at premiums that would be unaffected by the demutualization, but would receive shares of stock in a new holding company..." in exchange for the old mutual insurance company ownership interest (substituted basis in tax free reorganization).**

### **Key Facts in Fisher**

**The trust opted for the "cash election," so Sun Life sold the [new] shares on the open market for \$31,759.00.**

## Key Facts

- **The cash surrender value of Fisher’s policy, when demutualization occurred, was \$185,172.79.**
- **Total policy premiums paid through this time were \$194,343.64.**

## Holdings – Open Transaction Doctrine

- **The open transaction doctrine applies to the payments for the new stock.**
- **Because the value of the ownership interest in the mutual insurance company could not be determined (as a % of the total value of the insurance policy) Fisher is allowed to recover his ENTIRE policy basis first.**
- **The mutual insurance company ownership was not worth zero!**

## Holdings – Tax Free Recovery

**When the stock was sold for \$31,759:**

**“...the value of the ownership rights was not discernible, ... That being the case, and the amount received by plaintiff being less than its cost basis in the insurance policy as a whole [implicitly \$194,343.64 total premiums], ...plaintiff, in fact, did not realize any income on the sale..., therefore, is entitled to the requested refund.”**

## Likely Relevance of Recent Rulings

- **On facts similar to Fisher, the new IRS position will be that the cost basis in the insurance policy must be reduced by the “cost of insurance”.**
- **If the policy has a cash surrender value (Fisher), this would be the total premiums (\$194,343.64 in Fisher) minus the portion that is the “cost of insurance”.**
- **With term life insurance, which does not have a cash surrender value, the cost of insurance” will constitute a much greater portion of the premiums.**