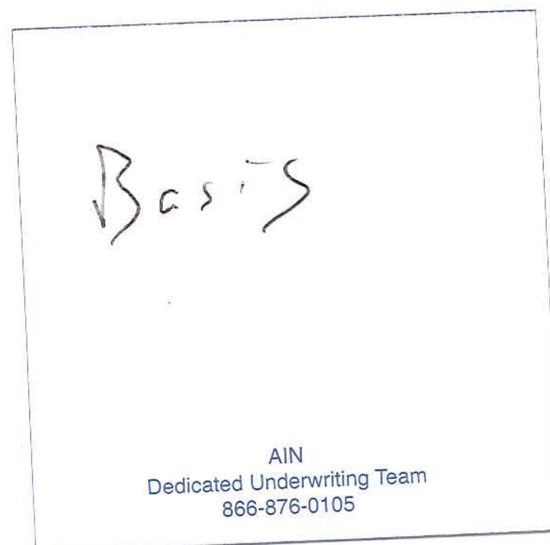
SOCIETY OF ACTUARIES

Article from:

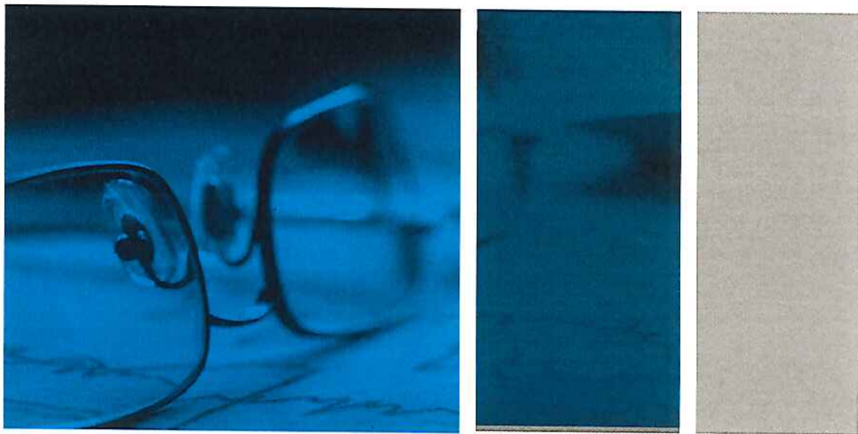
Taxing Times

February 2013 – Volume 9 Issue 1



IT'S ABOUT BASIS … AND MOORE

By John T. Adney and Bryan W. Keene



In three cases decided last summer, the federal courts were asked to address the income tax "basis" associated with life insurance contracts. As detailed below, in two of those cases, the courts did so: *Dorrance* struggled with the long-standing question of how to allocate cost basis between shares of stock received in a demutualization and the life insurance contracts that gave rise to the shares, while *Brown* confirmed an Internal Revenue Service ("IRS") (and insurance company) calculation of the excess of contract termination proceeds over the policyholder's "investment in the contract" to determine the gain taxable to the policyholder. In the third case, however, the court in *Moore* dismissed the IRS' (and the insurer's) determination of basis and hence of contract termination gain, concluding instead that the contract had in fact terminated decades earlier.

THE DEMUTUALIZATION ISSUE: *DORRANCE V. UNITED STATES*

Since the modern wave of life insurance company demutualizations began in the 1980s, the IRS has expressed the view that the cost basis of a policyholder's shares of stock received in a demutualization is zero. The rulings that the IRS issued to demutualizing companies took this position despite the fact that the IRS, like most others, acknowledged that there was value associated with the participating contract rights, *i.e.*, to vote for mutual company directors and share in divisible surplus. That those rights had substantial value was evidenced by the fact that they ultimately were converted into shares of the demutualized company. That said, a precise dollar value has never been assigned to such participation rights, let alone to their cost. The IRS view essentially allocated all of the value arising from the premiums paid for life insurance contracts issued by former mutuals to the contracts' benefits apart from the participation rights.

Several years ago, in *Fisher v. United States,* 82 Fed. Cl. 780 (2008), *aff'd per curiam,* 333 Fed. App'x 572 (Fed. Cir. 2009), the IRS' "zero basis" view was challenged by a policyholder who received cash (in lieu of stock) from the demutualizing insurer in exchange for his participation rights. The policyholder, who maintained his life insurance contract in force after the demutualization, contended that his cost in acquiring the rights he gave up in return for the cash received—embedded in the premiums theretofore paid for the contract—was greater than zero but not determinable as a practical matter, and hence that the tax law's "open transaction" doctrine should apply. Under that doctrine, which is rarely invoked today, the determination of the gain (if any) in a sale or exchange is held open and not taxed to the recipient until the cost basis of the property sold or exchanged has been fully recovered. The Court of Federal Claims took the extraordinary step of adopting this approach, thereby allowing the policyholder to avoid federal income tax on the cash he received and deferring tax on the gain (if any) from the demutualization transaction until such time as the life insurance contract was surrendered. Moreover, if the contract continued in force until the death benefit was paid, the gain involved in the cash payment would likely never be taxed. The Federal Circuit Court of Appeals affirmed the lower court's ruling without opinion.

Essentially the same situation, and the same proposed resolution, was presented to the U.S. District Court for the District of Arizona in *Dorrance v. Commissioner*, 877 F.Supp. 2d 827 (D.Az 2012). In that case, a life insurance trust established by the plaintiffs had the good fortune of purchasing sizeable life insurance contracts from some five mutual companies that demutualized not many years after the purchases. The trust thereby benefitted from the distribution of shares in each of those companies in connection with the demutualizations, and in turn it sold all of the shares for cash, but it continued to maintain the life insurance contracts in force. On the IRS Form 1099-B that the trust received as a result of the shares' sale, the basis of the shares was reported as zero, consistently with the IRS position, so the plaintiffs paid the tax due on the full value of the shares and then filed a claim for refund arguing that the open transaction doctrine applied. This led to the lawsuit.

The District Court agreed with the Court of Federal Claims that there was value in the participation rights subsumed in the shares distributed to the trust, but it disagreed with the latter's resolution of the tax issue *via* the open transaction doctrine. Responding to the plaintiffs' and the government's

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The five insurers involved in *Dorrance* perhaps could incorporate the ultimate settlement for their future reporting in that case. ...

cross-motions for summary judgment (the government adhering to the IRS' zero-basis approach), the District Court denied both motions and held that "[t]he basis in the life insurance policies 'shall be equitably apportioned among the several parts,'" quoting from the requirement in Treas. Reg. section 1.61-6(a) that applies when only a part of a piece of property is disposed of.[1] In an opinion that thoroughly discussed the open transaction doctrine, the court found that doctrine inapt to the circumstances of a demutualization. Specifically, it noted that under the standard for applying that doctrine articulated by the Supreme Court in *Burnet v. Logan*, 283 U.S. 404 (1931), the open transaction method of taxation is limited to a situation in which the value realized in the sale or exchange is contingent on future events or for some other reason cannot be determined at all at the time of the transaction. Nothing in the demutualization transaction presented such a situation, according to the court, which observed that "there is no question that at the time of demutualization, both the value of the stock and the market value of the policy itself [*i.e.*, on the secondary market] could be calculated."

After rejecting both the zero-basis approach and the use of the open transaction doctrine, the District Court turned attention to the manner in which the trust's basis in the life insurance contracts could be "equitably apportioned" between those contracts and the shares received in the demutualization. The court observed that, generally speaking, there is no single method for apportioning basis when only a part of a piece of property is sold, and it proceeded to summarize the views of several courts of appeals on the question. Concluding that the issue of apportionment was one for the parties to argue at trial, the court called to the parties' attention the case law of the Ninth Circuit Court of Appeals (to which the judgment in *Dorrance* could be appealed), which suggested the use of an apportionment method that compared the original cost of the mutual company contracts to the cost of similar contracts issued by stock companies. The court also called attention to the views of "commenters" on demutualization in particular, which "suggested that comparing the market value of the policy and the stock at the time of demutualization, and applying that ratio to the premium payments, would be more appropriate."

Following an apportionment approach, rather than that championed by the IRS or by the court in *Fisher*, potentially poses an intriguing puzzle for those saddled with filing Forms 1099-R, not to mention the Form 1040, for non-death distributions from life insurance contracts after a demutualization. Since the apportionment approach assumes that the cost of the participation rights subsumed in the shares (or cash) distributed by the demutualized company was paid as part of the premiums for the contracts, it would seem to follow that a reduction in a contract's basis due to such apportionment would translate into a comparable reduction in the section 72(e)(6) "investment in the contract" or "IIC."[2] While it is not always the case that an adjustment to a life insurance contract's basis results in an adjustment to the contract's IIC—the IRS itself recognized a distinction between basis and IIC in Revenue Ruling 2009-13,[3] discussed further below—in this instance it would appear logical, or at least plausible, that a basis reduction due to a portion of premiums being attributed to rights apart from a contract would give rise to a comparable reduction in the contract's IIC.

If so, then parties, including life insurers, who are required to determine taxable gain in reports to the IRS would need to incorporate the amount of that basis reduction into the IIC in their tax information systems. The IIC, after all, needs to be known in order to determine when amounts withdrawn from a life insurance contract that is not a modified endowment contract ("MEC") under section 7702A begin to be includible in income, and also to determine when amounts withdrawn from a MEC cease to be includible. But insofar as the IIC reduction due to apportionment is determined in an *ad hoc* manner, policyholder by policyholder, in settling arguments with the IRS, there seemingly is no way to administer such an approach systematically. The five insurers involved in *Dorrance* perhaps could incorporate the ultimate settlement for their future reporting in that case, but that result would not necessarily apply to any other policyholders. In contrast, where either the zero basis approach or the open transaction approach is followed, the IIC is not disturbed. The IRS could, perhaps, suggest a safe harbor formula to use, *e.g.*, treating some percentage of the pre-demutualization IIC as allocable to the shares, but if the agency continues to stand by its zero basis view for the shares, any such guidance is unlikely.[4]

Hence, Form 1099-R filers, along with insurers' and financial planners' illustration systems, are left with a conundrum if apportionment is to be used. And it is not just demutualized insurers that are left with this, for any insurer administering contracts issued in a section 1035 exchange makes use of the replaced contract's IIC as the starting point for the IIC of the new contract. To complicate matters further, the IRS main-

tains, per Situation 2 of Revenue Ruling 2009-13, that the basis of a life insurance contract in a sale setting (as opposed to the IIC on a full or partial surrender, addressed in Situation 1 of that ruling) must be reduced by the cost of insurance. Since the issue now left for decision in *Dorrance* is technically the apportionment of basis, not of the IIC, the IRS could argue that it is the shrunken basis—the premiums paid reduced by the cost of insurance—that must be apportioned, thereby leaving in its wake a greater putative reduction in the IIC going forward. If so, then taxpayers and tax reporters perchance could point to the same ruling in contending that basis is basis (Situation 2 of the ruling) whereas IIC is IIC (Situation 1), and the twain shall not meet, thus leaving the IIC undisturbed following a demutualization.

Suffice it to say that the apportionment approach sets up more issues for tax professionals to worry about. And worry may be the only result, for it seems doubtful, absent further instruction from the IRS, that tax reporting systems will be altered to reflect some reduction in the IIC of contracts issued by former mutuals. It also remains to be seen whether other courts, if and when asked, will side with *Fisher, Dorrance,* the IRS, or none of the above.

CALCULATING INVESTMENT IN THE CONTRACT: *BROWN V. COMMISSIONER*

As compared with *Dorrance,* the question asked of the courts in *Brown v. Commissioner,* 693 F.3d 765 (7th Cir. 2012), *aff'g* T.C. Memo. 2011-83 (April 12, 2011), is rather a tame one. Indeed, of greatest interest is why the question continues to be asked at all. In an article published in *Taxing Times* last year, Dan Stringham reviewed some five judicial decisions of recent vintage responding to taxpayers' claims quite similar to the one raised in *Brown,* as well as the Tax Court opinion in *Brown* itself.[5] In each of those prior cases, the taxpayer lost, as did Mr. Brown in the Seventh Circuit Court of Appeals.[6] The common theme throughout the cases is that life insurance contracts collapsed after heavy borrowing, insurers dutifully sent out Form 1099-R's, and the policyholders *cum* taxpayers thereby became aggrieved.

The facts in *Brown,* as laid out by the Seventh Circuit, were fairly straightforward as far as contracts with heavy borrowing are concerned. The policyholder purchased a participating whole life contract with a $100,000 face amount in 1982, paid level premiums of $1,837 annually during the first five years, and took loans under the contract to pay the next 14 years' premiums as they came due. During this time, the dividends under the contract were employed to purchase paid-up additional insurance ("PUAs"). Faced with the fact that the policy loans were then approaching the contract's cash value, the policyholder began paying part (but not all) of the next three years' premiums in cash. The accumulated loans, however, were winning the race, and so in 2004, he directed that the PUAs be surrendered to reduce the debt and also that future dividends be applied to pay premiums as well as to reduce the debt. Unfortunately, these actions were insufficient to preclude the contract's cancellation at the end of 2005 due to borrowing in excess of the then cash value, which was in the $37,000 range.[7] This apparently led to the issuance of a Form 1099-R by the insurer showing a taxable amount exceeding $29,000, followed by a dispute between the policyholder and the IRS, followed by a petition to the Tax Court objecting to an IRS assessment. The IRS also assessed a 20 percent penalty based on a substantial understatement of income on the policyholder's income tax return, which the IRS found unsupported by "substantial authority." The Tax Court disagreed with the policyholder and held in the IRS' favor, sustaining the penalty along with the asserted tax deficiency.

Writing for the Court of Appeals, Judge Posner, an eminent jurist and a respected economic thinker, summarized the real gravamen of the lawsuit as only he could: "Naturally, [the policyholder] is loath to pay any tax in respect of the cancellation, since he received no money from it." The policyholder, after all, had borrowed all of the cash value to pay premiums to keep the contract alive for nearly 25 years. According to the court, the feat of maintaining $100,000 of whole life coverage in force over that extended period actually cost the policyholder, out of pocket, around $8,000—before the IRS made an appearance, that is. The policyholder, however, contended that the IIC for his contract was the sum of the premiums paid over that period—some $44,000—which should not be reduced (as the IRS and the Tax Court had earlier concluded) by either the dividends applied to pay premiums and pay down the accumulated borrowing ($5,000, roughly) or by the PUA surrender proceeds applied to the debt (about $31,000), totaling to nearly $36,000. Judge Posner's summation of the policyholder's motivation in this case very likely applies to the motivation behind all of the predecessor cases, too.

To assess the merits (or not) of the policyholder's contention, the Court of Appeals, like the Tax Court before it, was called on to calculate the IIC. This is not surprising, as courts have been asked to engage in this calculation with some frequency.[8] The policyholder, if correct in his contention, would have sustained a (non-deductible) loss of almost $7,000, *i.e.*, $37,000

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of cash value deemed distributed on contract termination less the $44,000 IIC. The Court of Appeals, however, calculated the IIC very differently: the IIC, said Judge Posner, was $44,000 less the $5,000 in dividends applied to pay down debt (and cover two premiums) and also less the $31,000 in PUA surrender proceeds applied to the debt, for an IIC of only about $8,000. Hence, the $29,000 amount includible in income pursuant to section 72(e), on which the IRS assessed the tax deficiency, was correct in the court's view, *i.e.*, the $37,000 cash value at the time of contract termination less the $8,000 IIC produced a positive difference of $29,000.

While the foregoing would not appear as news to most tax professionals,[9] one exchange of thoughts between the policyholder's advocate and the court is worth noting. The court's opinion recorded that the policyholder claimed the PUA surrender proceeds and dividend payments utilized to reduce the large indebtedness (and pay a couple of years' premiums) should be treated as "dividends … retained by the insurer" within the meaning of section 72(e)(4)(B), and thus should be excluded from income as that rule provides. Accordingly, the argument went, they should have no effect on the IIC, up or down. The court responded that section 72(e)(4)(B) "does not apply to non-annuity life insurance payments," citing to section 72(e)(5)(A)(i) and (C). As a matter of statutory construction, this was correct, assuming that the contract in question was not a MEC; that seems a safe assumption, since the contract was a level premium whole life contract issued in 1982. If the contract were a MEC, or if an annuity had been involved, the (e)(4)(B) rule would have applied as a technical matter with respect to the dividends retained to pay premiums.[10] Further, the PUA surrender proceeds, while originating in dividends applied to purchase the paid-up coverage, clearly represented cash value that contained earnings accretions over time, or in other words, "inside buildup." The recapture of PUAs' cash value to support a base contract does not fall within the (e)(4)(B) rule.[11]

The final matter addressed by the Court of Appeals was the substantial understatement penalty assessed by the IRS. That penalty, equal to 20 percent of the tax deficiency, added over $1,700 to the policyholder's tax bill of approximately $8,500. The penalty could be avoided if the taxpayer's failure to include the income on his return was premised on "substantial authority," and the Treasury regulations list a number of items that can be employed for this purpose, spanning the gamut from statutes to private letter rulings. Unfortunately for the policyholder, none of those items could be cited as supporting the policyholder's litigating position. Despite this, the penalty could still be sidestepped if the policyholder made reasonable efforts to determine his tax liability. The court found this lacking as well: "The taxpayers in this case are an attorney couple who made no effort to research the legal basis for their position, or obtain an opinion from an accountant or lawyer, until the Internal Revenue Service challenged their position." And so the penalty was sustained.

THE SURPRISE TERMINATION: *MOORE V. COMMISSIONER*

The IRS apparently thought that *Moore v. Commissioner*, T.C. Summary Opinion 2012-83, should turn out pretty much the same way as *Brown* and all its predecessors did. But the Tax Court had other ideas, and thereby hangs a tale.

In *Moore*, a policyholder who represented himself in front of the Tax Court purchased a participating, level premium whole life contract with a $20,000 face amount in 1975, simultaneously electing the application of the contract's automatic premium loan provision ("APL") to cover through borrowing any premium payments due but unpaid. The policyholder paid the first few years' premiums in cash but then stopped making payments, apparently believing (as the court found) that the contract eventually would terminate according to its terms. However, since the APL had been elected, the insurer began employing policy loans to pay the future premiums as they came due. And at this stage, the facts become intriguing.

According to the insurer's records as replicated in the Tax Court's opinion, the contract continued on in this fashion for more than 30 years, terminating its status as whole life in 2008 due to accumulated borrowing that exceeded the contract's cash value, and then terminating altogether in 2010 when the contract's extended term insurance coverage expired without value. The contract achieved this life span, *via* APL-based premium payments together with some dividends, even though only $472 in premiums had been paid by the policyholder out of pocket, which was equal to about 18 months of the contractual premium at issue. In other words, $472 in premiums—about a year-and-a-half's worth—had sustained $20,000 in whole life coverage for over a generation. This seems less like the miracle of compound interest than it does the miracle of loaves and fishes. To make matters more interesting for the policyholder, he apparently did not recall the APL election and did not learn of the APL's use to sustain the policy in

force until a letter arrived from the insurer in 2005 informing him of this. Additional letters arrived over the next few years, culminating in a 2008 letter announcing that the contract was in default and was converted to extended term status, with the premium loans being converted to permanent withdrawals.[12] This made the situation much worse for the policyholder, for it presented him with deemed taxable income (according to the insurer's calculation) of nearly $18,000 for the 2008 tax year, and of course did so without any cash distribution. There followed an IRS notice of tax deficiency to the policyholder and the policyholder's petition to the Tax Court, in a proceeding under section 7463 that resulted in a decision that is not appealable to any other court and does not count as precedent.

It appears that the IRS thought it a simple matter to lead the Tax Court through the section 72(e) calculation, comparing the loan payoff of roughly $21,600 in 2008 with the IIC at the time (premiums less dividends) of around $3,700 and thereby establishing that the alleged income of almost $18,000 was in fact correct. What's more, the burden of establishing the facts generally rests with the taxpayer, as the IRS' determinations in a notice of deficiency typically are presumed correct. But that is where the matter turned fatally worse for the IRS, for in certain circumstances, under section 7491(a)(1) and (2), the burden of proof shifts to the IRS. The court found that those circumstances were present in *Moore*, for *inter alia* the policyholder/taxpayer/petitioner introduced credible evidence regarding his life insurance contract's operation and why it should be viewed as having terminated decades before 2008. Given the seeming oddities in the record before the court, based largely on the insurer's records and correspondence, this placed the IRS at a disadvantage.

While the Tax Court agreed that using a life insurance contract's cash value to satisfy policy loans is treated as a distribution to the policyholder, citing the court's own precedents to that effect, the court had serious problems with the supposed facts in the case. In particular, the court took issue with the contention that the contract had been kept alive for over three decades via the APL on a record showing that the premiums due were not timely paid through the automatic borrowing. Rather, based on the court's inspection of the insurer's records, the court concluded that the contract had gone into default by the contract's own terms within the first few years of its existence. The IRS, it appears, offered nothing to counter this: "Respondent's [*i.e.*, the IRS Commissioner's] argument would have us construct a multitude of inferences

in his favor and simultaneously turn a blind eye to several unexplained discrepancies in the record. This we will not do." In other words, albeit less elegant ones, the IRS claims that the contract remained in force for over 30 years based on $472 in unborrowed premiums was not credible. On this basis the court concluded that the policyholder was not liable for the 2008 tax deficiency.

Anyone attempting to decipher the facts in the *Moore* case will indeed encounter unexplained discrepancies, even apart from the mystery of the mostly free whole life contract. The IIC calculation offered as part of the record in the case, for example, showed some $5,000 in dividends that reduced the IIC. That is the sole mention of the dividends, apart from the court's comment that there was no supporting documentation concerning them. If the dividends had been paid out in cash to the policyholder, that would have been a reason to subtract them in determining the IIC. It also would have been a sign to the policyholder that the contract remained in force, but neither the policyholder nor the IRS said anything further about them. Perhaps it is just as well that the opinion in *Moore* cannot be treated as precedent, for if it were, considerable time would hereafter be consumed attempting to comprehend the facts of a truly odd situation.

CONCLUDING THOUGHTS

The decisions in *Dorrance, Brown* and *Moore* represent the latest efforts of the courts to determine taxable gain associated with life insurance contract transactions, requiring the resolution of questions involving the contracts' basis or IIC. The

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District Court's conclusion in *Dorrance* that the premiums paid for contracts issued by former mutual companies need to be apportioned between the post-demutualization contracts and the shares issued (or cash distributed) in the demutualizations has rendered the situation potentially unsettled, for policyholders, insurers and the IRS. The conclusion of the Court of Appeals in *Brown*, on the other hand, served to confirm what many others had said before, although the fact that the issue was raised by the policyholder/taxpayer at all leaves one wondering. And perhaps the greatest wonder of the trilogy is the *Moore* case itself, which found no tax due because of the absence of a contract. It is not unusual to see a case brought to the courts claiming that an insurer wrongly denied the in-force status of a contract, but it is virtually unique to see a court decide, as the Tax Court did, that the insurer's claim that a contract had been in force was itself wrong.

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END NOTES

1 The Court of Federal Claims had also considered the applicability of Treas. Reg. section 1.61-6 in *Fisher*, but concluded that the demutualization facts presented were "one of the 'rare and extraordinary' situations in which the 'open transaction' exception to Treas. Reg. § 1.61-6 should apply."

2 Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

3 2009-21 I.R.B. 1029. This ruling is discussed in Frederic J. Gelfond and Yvonne S. Fujimoto, *Recent Guidance Involving the Taxation of Life Settlement Transactions*, 5 TAXING TIMES 27 (Sept. 2009).

4 Although the IRS has not publicly announced any intention to abandon its "zero basis" litigation position, a recent development in another demutualization case suggests some potential movement on the issue. In *Cadrecha v. United States*, 109 A.F.T.R. 2d 2012-1664 (2012), the taxpayer sold stock that he had obtained when the issuer of his life insurance contract demutualized. He paid tax on the sale as if he had no basis in the stock, but subsequently learned of *Fisher*, which was then-pending in the Court of Federal Claims. Thus encouraged, he filed an amended return in the hopes of protecting a claim for refund pending the outcome in *Fisher*. After an extensive series of letters and conversations between the taxpayer (or his accountant) and the IRS, during which time the Court of Federal Claims decided *Fisher* against the government, the IRS denied Mr. Cadrecha's claim on the grounds that the statute of limitations had run. He then filed suit in the Court of Federal Claims, *i.e.*, the *Fisher* court. The court, however, agreed with the statute of limitations point and ruled against the taxpayer, even though it saw the result as "harsh" in light of the record. The taxpayer, too, saw harshness in the result and filed an appeal with the U.S. Court of Appeals for the Federal Circuit. Then things got interesting. Before the government filed its brief in the appeal, it settled with the taxpayer. The government's motion to the court describing the settlement said that the Department of Justice had conferred with the IRS Chief Counsel regarding the government's position in the case, and that following the consultation the government's lawyers approached the taxpayer's lawyer to discuss a potential settlement. A deal was struck where the IRS would refund a portion of the income tax payment in question and the taxpayer would agree to dismiss his appeal. This eliminated the possibility that the government might lose the procedural issue on appeal and thus be faced with defending the same substantive arguments that the Court of Federal Claims had already shot down in *Fisher*. Of course, the motion describing the settlement makes no mention of how, if at all, it might affect the taxpayer's IIC with respect to the life insurance contract from which all these issues sprang in the first place.

5 Daniel Stringham, *After Going 0 for 6 in the United States Tax Court, Will Taxpayers Finally Give Up the Fight?* 7 TAXING TIMES 39 (Sept. 2011).

6 Since Dan Stringham's article and the Court of Appeals decision in *Brown*, yet another case on this subject made its way through the Tax Court, with the taxpayer once again coming out on the losing end. *See* White v. Commissioner, T.C. Summary Opinion 2012-108 (Oct. 31, 2012). So, the answer to the question that Dan posed in the title of his article is, apparently, "no."

7 Note that this and the following numbers in this article are approximate due to (1) the ease of reading and comprehending them and (2) the fact that the authors are lawyers, not actuaries.

8 *See, e.g.*, Gallun v. Commissioner, 327 F.2d 809 (7th Cir. 1964); Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960), *rev'g* 30 T.C. 866 (1958); London Shoe Co. v. Commissioner, 80 F.2d 230 (2d Cir. 1935).

9 The details of the IIC calculation are as follows. The owner paid premiums of $12,000 in cash. He paid another $28,000 using the proceeds from policy loans. This was just as if the owner had borrowed the money from a bank and used that cash to pay the premiums. Lastly, he paid $4,000 by instructing the insurer to retain dividends as premium payments (see note 10, *infra*, for more on these dividends). This all sums to $44,000, which is the aggregate amount of premiums paid for the contract within the meaning of section 72(e)(6)(A). In order to determine the IIC, section 72(e)(6)(B) requires that the foregoing sum be reduced by any excludable amounts received under the contract. The owner received a total

of $36,000 in such excludable amounts, which reduced his IIC from $44,000 to $8,000. Specifically, he surrendered PUAs that reduced the contract's cash value by $31,000. Even though the insurer retained that amount to pay down policy loans, it was still a distribution of cash value, just as if he had borrowed from a bank and surrendered the PUAs to pay the bank loan. And because the contract was a non-MEC, the PUA distribution was excludable to the extent of the IIC (*i.e.*, the section 72(e)(2)(B) "income-first" ordering rule did not apply). In addition, the owner instructed the insurer to use $1,000 in dividends to pay down policy loans. This, too, resulted in a distribution from the contract, which was excludable from gross income for the same reason as the surrendered PUAs. Finally, the owner received the $4,000 in dividends, described above, that the insurer retained to pay premiums under the contract. This, too, resulted in a deemed distribution from a non-MEC that was excludable to the extent of the IIC. Note, however, that the treatment of these dividends effectively results in a "wash" in determining the IIC; they are subtracted from the IIC when deemed distributed, then added back to the IIC when paid into the contract as new premium.

[10] One can hardly blame the taxpayer for arguing that section 72(e)(4)(B) applied, at least to the dividends that the insurer retained to pay premiums. After all, that section specifically refers to dividends retained for such purpose. However, (e)(4)(B) says only that such dividends are not included in gross income under the income-first ordering rule of section 72(e)(2)(B). Thus, if a contract—like a non-MEC—is not subject to the income-first rule at all, the (e)(4)(B) rule has no relevance, which the court observed. Nonetheless, the result is largely the same for the $4,000 of dividends retained to pay premiums when you view them as deemed distributions from a non-MEC, because they will be excludable to the extent of the IIC.

[11] *See, e.g.*, H.R. Rep. No. 100-1104, Vol. 2, at 102 (Conf. Rep.) (1988) (discussing the distribution rules applicable to modified endowment contracts).

[12] For the most recent 12 years, the taxpayer lived at the same address and received mail from the insurance company there. The court noted, however, that the taxpayer "generally believed that this mail was marketing materials."

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