Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

from:

(Income Tax & Accounting)

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer :

Insurer :

ISSUES

Whether damages from a class action lawsuit against Insurer are includible in the Taxpayer’s income.

CONCLUSIONS

Because a return of basis is not generally classified as income within the meaning of section 61, the Taxpayer's damages are not includible in the Taxpayer's gross income to the extent of the Taxpayer's basis in the insurance policy.

FACTS

Taxpayer had two life insurance policies with Insurer. The first policy, a $ million policy on her former husband, was issued on . Five years later, the death benefit was reduced to $. According to the revenue agent, the Taxpayer paid $ in premiums up to the date of the policy's conversion of the policy.

The second policy, issued on , was on the Taxpayer's own life with a death benefit of $. This policy was surrendered sometime in .

A class action lawsuit was brought against Insurer. According to the Class Action Complaint against Insurer, the Insurer "fraudulently induced class members to surrender, borrow against or otherwise withdraw values from their existing policies in order to purchase new policies. In so doing, defendants misrepresented the true financial effect of the transaction and uniformly failed to disclose to class members" that the switch was against the best interests of the class members. Specifically with respect to the Taxpayer, the Insurer engaged in misrepresentations to encourage the Taxpayer to convert her $ million policy to the $ policy by erroneously guaranteeing that no additional premiums would be necessary if she used the cash surrender value of the $ million policy to pay for the $ policy.

In 2001, Taxpayer was awarded $ in a class action lawsuit. This includes $ with respect to the $ policy. Out of the $ of damages, approximately $ represents interest. The Taxpayer concedes that the portion of the damages representing interest (approximately $) is taxable.[1]

The damages of the taxpayer were intended "to offset or reduced all or partly of any sale load and other additional costs the policy owner may have paid in connection with replacing policy." The Taxpayer asserts and the Revenue Agent and Area Counsel concede that no portion of the settlement award represents punitive damages.[2] On the

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1 Under section 61(a)(4) of the Code, interest is an item includible in gross income. See also Wheeler v. Commissioner, 58 T.C. 459 (holding any portion of a judgment which compensates a taxpayer for the lost use of his money substitutes for interest and is taxable as ordinary income); Rev. Rul. 76-133, 1976-1 C.B. 34.

2 Under section 1.61-14(a), punitive damages are includible in gross income. See also Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955) (holding punitive damages includible in gross income because punitive damages are not a substitute for any amounts lost by the plaintiff or a substitute for any injury to

Taxpayer's 2001 return, she reported the entire settlement as income. Taxpayer later amended her return claiming a refund in the amount of $, the amount of damages in excess of interest. (In later correspondence, the Taxpayer asserts that the amount over-reported was $).

Taxpayer's Position

Taxpayer argues that the damages represented the recovery of actual out-of-pocket expenses paid by the Taxpayer. Because the Taxpayer paid the premiums and costs with after-tax dollars, damages excluding interest, should not be subject to tax.

Revenue Agent's and Area Counsel's Position

Area Counsel asserts that the Taxpayer paid approximately $ in premiums on the $ million dollar policy and $ of that amount was credited against the replacement policy. Area Counsel argues that the taxpayer should not receive all of the $ non-interest damages tax-free because the taxpayer received the benefit of the original policy for five years (if Taxpayer's former husband had died during the five years, she would have collected a death benefit of $ million dollar) and currently has the benefit of the replacement life insurance policy. Consequently, the entire cost of the $ million dollar life insurance policy that the Taxpayer paid during the 5 years does not represent a loss.

Instead, the Taxpayer's loss should be represented by "the difference between the cash value of the original policy and the cash value of the replacing policy." The revenue agent has calculated these figures to be $ and $ for a loss of $. Accordingly, Area Counsel believes that $ of the damages is nontaxable. Additional clarification revealed that Area Counsel believes that the Taxpayer's losses should be limited to the amount of the overcharge reduced by the value of the current replacement policy and the value of $ million dollar policy for the 5 years.

LAW AND ANALYSIS

Under section 61 of the Internal Revenue Code, gross income means all income from whatever source derived, including income for life insurance contracts. See section 61(a)(10). Any receipt of funds or other accessions to wealth received by a taxpayer is presumed to be gross income unless the taxpayer can demonstrate that the funds or accessions fit into one of the exclusions provided by other sections of the Code. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-31 (1955).

However, the receipt constituting a return of basis is generally not classified as income within the meaning of section 61 because it is not an accession to wealth. For

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the plaintiff or plaintiff's property, but are extracted from the wrongdoer as punishment for unlawful conduct; Rev. Rul. 84-108, 1984-2 C.B. 32.

payments received in settlement of a lawsuit, payments by the one causing a loss that do no more than restore a taxpayer to the position he or she was in before the loss was incurred are not includible in gross income because there is no economic gain to the recipient. See Raytheon Products Corp. v. Commissioner, 144 F.2d 110 (1st. Cir. 1944) (stating if a recovery is treated as a replacement of capital, the damages received from the lawsuit are treated as a return of capital and are taxable only to the extent that the damages exceed the basis of the property replaced). Cf. Clark v. Commissioner, 40 B.T.A. 333 (1939), acq., 1957-1 C.B. 4, and Rev. Rul. 57-47, 1957-1 C.B. 23.

Under section 1001(a), gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain. Section 1001(b) provides that the amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of the property (other than money) received. Section 1001(c) provides that except as otherwise provided in subtitle A of the Code, the entire amount of the gain realized under section 1001(b) must be recognized.

Century Wood Preserving Co. v. Commissioner, 69 F.2d 967 (3rd Cir. 1934), involved a corporation that purchased life insurance policies on the lives of its officers naming itself as the beneficiary. The corporation later sold the insurance policies to the officers based on the cash surrender value at the date of sale. The corporation asserted that the difference between the selling price of the policies and the amount of premiums previously by the corporation should be deductible losses. The court stated:

> The cost of an asset is the real question here. It is obvious that cost is not the total amount paid in as premiums, since continuing insurance protection is part of the consideration of the contract. The part of the premiums which represent annual insurance protection has been earned and used. The other part of the premium is an investment built up as a reserve until the policy is matured or surrendered. If it is surrendered, the holder is entitled to the cash surrender value from the insurer, or roughly, the return of the equivalent of his investment after the cost of annual protection is deducted from premiums. Id. at 968.

The court concluded that the cost of the policies was appropriately reflected by the cash surrender value of the policies because the surrender value is the amount of premiums reduced by the sum of the cost of the insurance protection and any amounts received under the contract that have not been included in gross income. Because the corporation received an amount of consideration equal to the surrender value of the policies, there was no gain or losses resulting from the transactions.

In Rev. Rul. 70-38, 1970-1 C.B. 11, involving the identical fact pattern as Century Wood, the ruling holds that the corporation is not required to include in its gross income the amount received from the sale of the insurance policies.

In the present case, the question is whether the amount of damages (excluding interest) received by the receipt constitutes a return of basis. Under section 1001 and Century

Wood, the basis of the Taxpayer's former $ million life insurance policy is equal to the amount of premiums paid by the Taxpayer less the sum of (i) the cost of insurance protection provided through the date of sale (such as, loading charges, expense charges, mortality charges and administrative fees) and (ii) any amounts received under the contract that have not been included in gross income. No adjustments should be made for the benefit of the original policy for five years or the benefit of the replacement life insurance policy. A determination of basis in the present case is a question of fact. We are unable to determine the basis in the Taxpayer's $ million policy from the case file.

With respect to the $ policy, because the policy was already surrendered by the Taxpayer, the entire $ of the damages attributable to the $ policy should be included in the Taxpayer's gross income.

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Please call if you have any further questions regarding this memorandum.