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Handling Losses on Surrender of a Life Insurance Policy

-by Neil E. Harl*

The issue of deductibility of losses on surrender of a life insurance policy or policies has loomed as the interest rates prevailing at the time insurance policies were taken out have fallen, producing economic losses (and what might, at first glance, appear to be tax losses) on surrender of the policy.[1] The rules are different, it should be noted, for the surrender of annuities without life insurance features.

General considerations

A statutory framework has been provided for exchanges of life insurance policies[2] which, through 2009, includes an exchange of a life insurance contract for an endowment, annuity or other life insurance contract; an exchange of an endowment contract for another endowment contract that provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged; an exchange of an endowment contract for an annuity contract; and an exchange of an annuity contract for another annuity contract.[3] However, a statutory framework has not been provided for the surrender of life insurance and endowment contracts that do not involve an exchange.[4]

Surrendering life insurance and endowment contracts

The consequences of surrender of life insurance and endowment contracts have, however, been the subject of litigation dating back to 1930 both as to the reporting of gain and as to the deductibility of losses. As explained in more detail below, other than for an early decision to the contrary, the clear consensus is that losses on surrender of life insurance and endowment contracts are not deductible either as ordinary losses or as capital losses.

Forbes Lithograph Manufacturing Co. v. White. In 1930, the United States District Court in Massachusetts decided the case of *Forbes Lithograph Manufacturing Company v. White*,[5] which involved a loss sustained by a corporation on the surrender of insurance policies on the lives of four of its officers. The court held that the loss was deductible in the amount of the difference between the total premiums paid on the policy and the policy's cash surrender value. The court was influenced by *Lucas v. Alexander*,[6] which the court interpreted as holding that a gain under similar circumstances was taxable. As the District Court in *Forbes Lithograph*,[7] stated ". . . the principle is adopted of setting up . . . an account by taking the total amount paid in on one side, and the total amount received when the transaction is closed out on the other side." As the court noted, in *Lucas v. Alexander*,[8] that rule was applied in that case where "the policies were closed out at a profit; it is equally applicable here where the policies were closed out at a loss."

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The holding in *Forbes Lithograph*[9] has been eclipsed by later decisions[10] as noted below.

London Shoe Company v. Commissioner. In 1935, five years after *Forbes Lithograph*,[11] the United States Court of Appeals for the Second Circuit decided the case of *London Shoe Company v. Commissioner*.[12] The case involved a life insurance policy in the amount of $100,000 taken out in 1924 on the life of the company president. London Shoe Company was the owner as well as the beneficiary of the policy. The life insurance contract carried a gross annual premium of $9,097. The company paid the premiums until 1931 which, by that time, totaled $63,679 with dividends amounting to $13,117. That left $50,562 as the net amount expended for the insurance. The company did not deduct the premiums as a business expense during those years. In 1931, the policy was surrendered (and cancelled) with the company as the policy owner receiving $24,600 which was the cash surrender value of the policy. The company claimed a deductible loss for federal income tax purposes of $25,692 based upon the difference between $50,562, the net cost of the insurance, and the cash surrender value of $24,600. The Commissioner denied the deduction and the Board of Tax Appeals (the predecessor of the Tax Court) upheld the Commissioner.

The Second Circuit affirmed on appeal, holding that the cash value which the company received represented essentially the excess premium payment set apart as the reserve under the policy. The portion of the premiums not used to build up the reserves was paid to obtain the insurance protection between 1924 and 1931. Therefore, there was no deductible loss. The appellate court specifically rejected the reasoning of *Forbes Lithograph*,[13] stating that there was no statutory provision for instances where the premiums paid exceeded the cash surrender value and held that there was no deductible loss where the amount of premiums paid exceeded the cash surrender value.

The Second Circuit cited, approvingly, a Third Circuit Court of Appeal case, *Century Wood Preserving Co. v. Commissioner*.[14] That case had likewise held that a corporate taxpayer was not entitled to deduct as a business loss the difference between the cash surrender value of a life insurance policy and the amount of premiums paid. The Second Circuit further noted that the Board of Tax Appeals had faced the issue in several cases including *Keystone Consolidated Publishing Co*.[15] and *Standard Brewing Co*.[16] and had held consistently that the difference between the cash surrender value and the net premiums paid was not deductible as a loss. A dissenting justice in the *London Shoe Co*. case would have followed *Forbes Lithograph Mfg. Co*.

In 1955, IRS cited approvingly to *Century Wood Preserving Co*.[17] on this issue.[18]

It is generally accepted today that losses from the surrender of life insurance and endowment contracts are not deductible. That is the case even if the policy or policies are taken out in connection with a business transaction. The difference between the premiums paid and the cash surrender value represents part of the cost of current insurance protection so that the holder of the policy has essentially received consideration equal to the amount of the alleged loss, thus precluding any loss to the taxpayer, the owner of the policy.

This outcome does not apply to annuities where there is no life insurance protection involved. In that situation, losses sustained in connection with the surrender or forfeiture of an annuity contract may be deductible as losses on a transaction entered into for profit.

FOOTNOTES

[1] See Harl, *Agricultural Law* § 28.05[14] (2008); 2 Harl, *Farm Income Tax Manual* § 4.01[1][n] (2007 ed.).

[2] I.R.C. § 1035.

[3] I.R.C. § 1035(a); Treas. Reg. § 1.1035-1.

[4] I.R.C. § 1035(a).

[5] 42 F.2d 287 (D. Mass. 1930).

[6] 279 U.S. 573 (1929).

[7] Note 5 *supra*.

[8] Note 6 *supra*.

[9] See note 5 *supra*.

[10] See London Shoe Co. v. Comm'r, 80 F.2d 230 (2d Cir. 1935); Century Wood Preserving Co. v. Comm'r, 69 F.2d 967 (3d Cir. 1934). See Keystone Consolidated Publishing Co. v. Comm'r, 26 B.T.A. 1210 (1932); Standard Brewing Co. v. Comm'r, 6 B.T.A. 980 (1927). See also Rev. Rul. 55-257, 1955-1 C.B. 428.

[11] Note 5 *supra*.

[12] 80 F.2d 230 (2d Cir. 1935), on appeal from the Board of Tax Appeals.

[13] Note 5 *supra*.

[14] 69 F.2d 967 (3d Cir.1934).

[15] 26 B.T.A. 1210 (1932).

[16] 6 B.T.A. 980 (1927).

[17] Notes 10 and 14 *supra*.

[18] Rev. Rul. 55-257, 1955-1 C.B. 428.