15 T.C. 93 (1950)

The fair market value of a single premium life insurance policy received in an exchange is the cost of the policy at the time of exchange, not its cash surrender value.

Summary

Parsons exchanged endowment life insurance policies for new life insurance policies and a small cash refund. The IRS determined Parsons had a taxable gain based on the cost of the new single premium policy, whereas Parsons argued the taxable gain should be calculated using the cash surrender value. The Tax Court held that the fair market value of the new policy was its cost at the time of the exchange, not its cash surrender value, because the cash surrender value only represents the value of a surrendered policy and undervalues the investment and protection aspects of the policy.

Facts

Parsons, upon the suggestion of an insurance agent, exchanged his endowment life insurance policies with Northwestern Mutual Life Insurance for ordinary and limited payment life policies. He also received a new single premium life policy for $8,500 and a small cash refund. The exchange increased Parsons' coverage from $27,000 to $38,000. Northwestern applied the total cash surrender value of the old policies, leaving a balance of $158.46, which Parsons paid. The new single premium policy cost $6,541.40 but had a cash surrender value of $5,531.02 on the date it was acquired.

Procedural History

Parsons reported a taxable gain based on his interpretation of Sol. Op. 55. The Commissioner determined a higher taxable gain, primarily due to the difference between the cost and the cash surrender value of the new single premium policy. Parsons petitioned the Tax Court, challenging the Commissioner's determination.

Issue(s)

Whether the fair market value (or cash value) of the new single premium life insurance policy received in the exchange is its cash surrender value or its cost.

Holding

No, the fair market value is the cost of the policy, because the cash surrender value only reflects the value of a surrendered policy and undervalues the policy's investment and protection aspects.

Court's Reasoning

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The court reasoned that a life insurance policy is property under tax statutes, and the exchange constituted a property exchange under Section 111(b) of the Internal Revenue Code. Fair market value is what a willing buyer would pay a willing seller without compulsion. The court rejected Parsons' argument that the cash surrender value represented the fair market value, stating that the cash surrender value is artificially set lower than the policy's reserve value to discourage surrendering the policy. The court emphasized that single premium life insurance policies appreciate over time, unlike other assets. The fair market value of a single premium life insurance policy at issuance is the price the insured (willing buyer) paid the insurer (willing seller). The court stated, "The cash surrender value is the market value only of a surrendered policy and to maintain that it represents the true value of the policy is to confuse its forced liquidation value at an arbitrary figure with the amount realizable in an assumed market where such policies are frequently bought and sold. Moreover, such an argument overlooks the value to be placed upon the investment in the insured's life expectancy and the protection afforded his dependents." The court cited Ryerson v. United States, stating the fair market value is "a reasonable standard and one agreed upon by a willing buyer and a willing seller both of whom are acting without compulsion."

Practical Implications

This case establishes that when determining taxable gain from an exchange of insurance policies, the fair market value of a new single premium policy is its cost at the time of the exchange. Attorneys should advise clients that the IRS will likely assess tax based on the policy's cost, not its cash surrender value. This ruling clarifies how to value these specific types of assets in exchanges, preventing taxpayers from undervaluing policies and underpaying taxes. Later cases would likely cite this case for the principle of valuing assets based on their cost at the time of the exchange, especially when dealing with single-premium insurance policies.

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