

Date: January 8, 1993

O.G.C. Precedent 1-93

From: General Counsel (022)

Subject: Treatment of Proceeds of Cashed-In Life
Insurance Policy for Improved-Pension Purposes

To: Under Secretary for Benefits (20)

QUESTION PRESENTED:

Are the proceeds of a life insurance policy that is surrendered by its owner for cash considered income for the purpose of determining entitlement to improved pension?

COMMENTS:

1. Title 38, United States Code, section 1503(a) (formerly section 503(a)), provides, with certain specified exceptions, that "[i]n determining annual income [for improved-pension purposes], all payments of any kind or from any source . . . shall be included." In determining whether the proceeds of a life insurance policy surrendered for cash are countable as income under section 1503(a), it is instructive first to consider whether such sums are addressed by any of the specific exclusions stated in that provision.

2. The only specific exclusion from pension income arguably applicable to proceeds from the surrender of a life insurance policy for cash is that applicable to "profit realized from the disposition of real or personal property" under 38 U.S.C. § 1503(a)(6) (formerly § 503(a)(6)). Life insurance policies may, under some circumstances, be considered property. See 12 John Alan Appleman & Jean Appleman, Insurance Law & Practice § 7006 (1981); 43 Am. Jur. 2d Insurance § 3 (1982). Personal property consists of "(1) corporeal personal property, which includes movable and tangible things, such as animals, furniture, merchandise, etc.; and (2) incorporeal personal property, which consists of such rights as personal annuities, stocks, shares, patents, and copyrights." Black's Law Dictionary 1217 (6th ed. 1990). Life insurance policies may be said to fall into the latter category.

3. In any event, however, use of the term "profit" in section 1503(a)(6) suggests that Congress contemplated the exclusion of proceeds from a sale or barter transaction involving marketable

property. Presumably, Congress used the term "disposition" rather than "sale" in order to cover barter transactions, although the legislative history focuses on property that is sold. See, e.g., Pensions: Hearing Before the Senate Comm. on Finance on H.R. 1927, 88th Cong., 2d Sess. 8 (1964) (testimony of John S. Gleason, Jr., Administrator of Veterans Affairs, referring to "profit realized from the sale of . . . property" in discussion of predecessor provision in bill which became Pub. L. No. 88-664). Unlike real estate or securities, a life insurance policy is not typically marketable.

4. The applicability of the income exclusion provision of section 1503(a)(6) also depends on whether the surrender of a life insurance policy for value may be deemed a "disposition" of property. The General Counsel has previously indicated that a conversion of assets from one form to another may be considered a disposition. O.G.C. Prec. 12-89. Cashing in a life insurance policy could be considered a disposition under a broad reading of the term. However, consideration of the nature of life insurance suggests that the transaction should not be considered a disposition.

5. The term "disposition" has been defined as the "parting with, alienation of, or giving up [of] property." Black's Law Dictionary at 471. The maintenance of an ordinary life insurance policy involves two transactions, the purchase of insurance coverage during the period for which premiums are paid and the accumulation of a savings or investment component. Upon surrender of the policy, the owner receives a refund of the savings component plus interest accrued on that amount. See generally, 1 Adrian A. Kragen & John K. McNulty, Federal Income Taxation: Taxation of Individuals 192 (1979); 1 Appleman, supra, § 2 (1981); 3A Appleman, supra, § 1764 (1967). The refund is not actually received in exchange for the cessation of the policy, but rather represents a return of the policy holder's investment upon termination of the contractual relationship. In receiving accumulated savings and interest upon cash surrender of a life insurance policy, the policy holder is essentially claiming his or her own money rather than alienating property and receiving different property in return. Thus, a disposition of property does not occur.

6. While the exclusion of profits from the disposition of property under section 1503(a)(6) does not apply to proceeds from the surrender of a life insurance policy for cash, the historical underpinnings of the exclusion are significant in

determining whether such proceeds are countable for improved-pension purposes. The profit exclusion was enacted as a liberalization of earlier VA practice, which had permitted the value of the property at the date of entitlement to pension to be excluded from income upon disposition of the property. See Digested Opinion, 12-4-64 (8-25 Income). In Op. G.C. 23-56 (5-2-56), the General Counsel had explained that only the gain from the sale of property constitutes income. In so concluding, the General Counsel reviewed several general definitions of the term income which indicated that term is generally defined as referring to gain derived from labor, business, or property. In enacting the liberalizing provision to exclude profit as well as recovery of the value of an investment, Congress implicitly endorsed VA's policy of excluding from a pensioner's income the return of an investment. Consistent with this longstanding policy, proceeds from life insurance surrendered for cash should not be considered income to the extent that such proceeds consist of sums originally paid as part of the insurance premiums, since such sums represent the recovery by the policy holder of funds invested in the policy.

7. In contrast, interest accumulated on the funds held by the insurance company represents a gain derived from the investment, and, since the (a) (6) exclusion is not applicable to payment of such sums, they must be considered income when paid. (In this regard, we note that, prior to the special statutory treatment of annuities discussed below, VA had viewed interest received from annuities, but not return of the annuitant's contributions of principal, as income for pension purposes. See Digested Opinion, 9-11-45 (8-25 Income); 81 Op. Sol. 15 (7-5-45).) Interest accrued while the policy remains in force would not be counted as income until paid, because the funds are not readily accessible to the policy holder without sacrifice until such time as he or she determines to terminate insurance coverage. See O.G.C. Prec. 70-90 (Accrued interest in an individual retirement annuity would not be counted as income where its withdrawal would result in a substantial penalty to the beneficiary; however, such interest would be counted as income when it is actually received by the beneficiary.).

8. We are aware that this office has also held that a payment received as a result of a pensioner's withdrawal of his or her contribution to a retirement fund should be considered income for improved-pension purposes, regardless of whether interest is included in the payment. O.G.C. Prec. 23-90. As indicated

in that opinion, under the major revision of the pension laws in 1959, see Pub. L. No. 86-211, § 2(a), 73 Stat. 432 (1959), payments from public or private retirement, annuity, and endowment plans were not considered countable income for pension purposes until the pensioner had recouped his or her own contributions to the plan. In 1964, Congress amended the pension statutes to provide for the exclusion of ten percent of "the amount of payments to an individual under public or private retirement, annuity, endowment, or similar plans or programs." See Pub. L. No. 88-664, § 1(a), 78 Stat. 1094 (1964). Congress eliminated the ten-percent exclusion when it enacted the improved-pension program under Pub. L. No. 95-588, § 102(a), 92 Stat. 2497 (1978). See H.R. Rep. No. 1225, 95th Cong., 2d Sess. 38 (1978), reprinted in 1978 U.S.C.C.A.N. 5583, 5619.

9. These developments were reflected in the holding of O.G.C. Prec. 23-90 that a withdrawal of retirement-fund contributions constitutes income. The legislative history on which O.G.C. Prec. 23-90 was based contains no reference to the surrender of life insurance policies, but only contains reference to payments from retirement funds, annuities, and endowment plans. Although surrender of life insurance for cash may be somewhat analogous to withdrawal from a retirement fund, Congress did not address the former transaction in its various amendments of the pension laws. In the absence of clear direction from Congress, VA should apply a liberal interpretation of the law in determining entitlement to veterans' benefits. See, e.g., O.G.C. Prec. 18-89. We conclude, therefore, that Congress' treatment of retirement, annuity, and endowment plan funds should not be extended by analogy to cover other types of proceeds.

10. Thus, proceeds from the surrender of life insurance should not be counted as income to the extent that such proceeds consist of moneys paid as part of the insurance premiums, since such sums do not represent a gain to the recipient, but merely a return of his or her investment. However, any portion of the proceeds which can be identified as interest on the policy holder's monetary contribution should be included as income for improved-pension purposes. In addition, 38 U.S.C. § 1522(a) requires that pension be discontinued when the corpus of the veteran's estate is such that, under all the circumstances, it is reasonable that some part of the corpus be consumed for the veteran's maintenance. Proceeds from the cashed-in life insurance would represent a liquid asset which must be considered in evaluating net worth for purposes of section 1522(a).

HELD:

Proceeds of a life insurance policy that is surrendered for cash should not be considered income for purposes of determining entitlement to improved pension under title 38, United States Code, to the extent that such proceeds consist of return of sums paid as part of the insurance premiums. Interest on the policy holder's monetary contribution should be considered income.

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