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AALU Bulletin No: 10-83

August 20, 2010

Subject: **Taxpayers Are Taxable On Insurance Rebates**

Major References: [\*Rickard v. Commissioner, T.C. Memo 2010-159\*](#)

Prior AALU Washington Reports: 98-63; 97-101; 95-62; 93-81

MDRT Information Retrieval Index Nos.: 4400.00; 8100.00

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THE CONCLUSION OF THIS WASHINGTON REPORT.**

*The Tax Court, following prior precedent, has ruled, in Rickard v. Commissioner, T.C. Memo 2010-159, that an insured realizes income to the extent of the value of insurance coverage measured by the amount of the first year's premium allegedly "paid" by their broker, who in turn received from the insured a promissory note in the approximate amount of that broker-paid premium. The court held that the note did not represent a valid indebtedness and thus was "illusory."*

Under the facts of the case, taxpayers (husband and wife residents of Tennessee), purchased three life insurance policies during 2001 through the same broker. In each instance the broker, through his corporation, Eagle Financial Group, Inc. (Eagle), issued a check to taxpayers to cover the cost of the initial premium on the policy. The taxpayers deposited that check and wrote their own check to the insurance company to pay the premium. The broker earned commissions on each of the policy sales that ranged from 110 to 145 percent of the initial premium. The checks for the three policies were in the amounts of \$5,778, \$195,250 and \$32,300, for a total of \$233,327.

On December 1, 2001, the husband of the taxpayer marital unit executed a recourse promissory note for \$201,108 in favor of Eagle. The note was payable 1 year from the date of execution, "with interest to be paid, at the rate of 3 per centum per annum, from date payment is due." As of the date of their trial, taxpayers had made no payments on the promissory note.

By early 2004, Taxpayers had cancelled all three policies. During 2003, one of the insurance companies brought suit against the broker, and his related companies alleging, among other things, that he engaged in the practice of “rebating”. According to the court, rebating can be described as the practice by which an insurance broker offers to pay the initial premium on an insurance policy (or provides some other consideration not authorized by the policy itself) to induce a buyer to purchase the policy from that broker. Rebating is defined as an “unfair trade practice” under the Tennessee Insurance code.

On their joint Federal income tax return for 2001, Taxpayers did not report as income any portion of the amounts received from Eagle in 2001, resulting in the issuance of an IRS notice of deficiency requiring them to include in income the \$233,327 they received from Eagle in 2001.

The Tax Court, relying on precedents established in *Sutter v. Commissioner*, T.C. Memo. 1998-250, *Haderlie v. Commissioner*, T.C. Memo. 1997-525, *Wentz v. Commissioner*, 105 T.C. 1 (1995), and *Woodbury v. United States*, 932 U.S.T.C. 50,528, aff’d per curiam, 27 F.3d 572 (8<sup>th</sup> Cir. 1994) (see our Bulletins Nos. 98-63, 97-10, 95-62 and 93-81), ruled that, “[w]hen a taxpayer purchases insurance coverage but, pursuant to a rebating scheme, receives a reimbursement of his premium payment from an insurance broker, the taxpayer has received income . . . measured by the amount of the premium reimbursement, or rebate, received [which] must be recognized in the year the rebate is received.”

Taxpayers argued, however, that they did not realize income from the reimbursements because the husband gave promissory notes to Eagle obligating him to repay the reimbursed amounts.

In response, the court noted that “[n]onrecourse notes provided by the taxpayer to the rebating insurance broker do not create genuine indebtedness where there is no evidence of an intention to repay the notes.” Although the promissory note that husband/taxpayer executed in favor of Eagle was recourse, the court nevertheless determined that the notes, in this case, “did not constitute genuine indebtedness.”

Determining whether a promissory note constitutes genuine indebtedness requires an examination of all of the facts and circumstances, including, most importantly, facts indicating a good faith intent of the debtor to repay and a good faith intent of the creditor to enforce repayment. Courts look to several factors in determining whether the parties had the requisite good faith intent, including: whether there was a written loan agreement, whether there was a fixed schedule for repayment, whether any security or collateral was requested, whether interest was charged, whether there has been a demand for repayment, whether the loan was reflected in the parties’ books, whether any repayments have been made, and whether the borrower was solvent at the time of the loan.

In this case, evidence of good faith was rebutted by the absence of any attempt to repay the notes, and the failure of a demand for repayment by the broker. Finally, there was no evidence that any collateral was provided. The Court therefore held that “there was no genuine indebtedness offsetting [taxpayers’] receipt of the \$233,327 in premium rebates in 2001.” Taxpayers thus received taxable income in this amount in 2001.

Any AALU member who wishes to obtain a copy of *Rickard v. Commissioner* may do so through the following means: (1) use hyperlink above next to “Major References,” (2) log onto the AALU website at [www.aalu.org](http://www.aalu.org), enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at [raglani@aalu.org](mailto:raglani@aalu.org) and include a reference to this *Washington Report*.

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