

Part I

Section 264.--Certain Amounts Paid in Connection with Insurance Contracts

(Also § 1035.)

Rev. Rul. 2011-9

ISSUE

Does the pro rata interest expense disallowance rule of § 264(f)(1) of the Internal Revenue Code apply to Old Policy and to New Policy in the situations described below?

FACTS

Situation 1. Taxpayer is a corporation engaged in a trade or business that has substantial indebtedness on which it incurs interest expense. On January 3, 2000, Taxpayer purchased a life insurance policy (“Old Policy”) covering the life of A, an employee of Taxpayer, as of that date. A was not a 20-percent owner, officer, or director of Taxpayer, and was the only individual covered by Old Policy. On January 3, 2011, Taxpayer received a new life insurance policy (“New Policy”) covering the life of A as of January 3, 2011, in exchange for Old Policy in a transaction that qualified for non-recognition of gain or loss under § 1035. New Policy also covers only the life of A and has the same death benefit as Old Policy. A remained an employee of Taxpayer as of

January 3, 2011. Both Old Policy and New Policy are life insurance contracts as defined in § 7702.

Situation 2. The facts are the same as in Situation 1, except that on January 4, 2010, A terminated employment with Taxpayer.

LAW

Under § 264(f)(1), no deduction is allowed for that portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values.

Section 264(f)(7) defines "interest expense" as the aggregate amount allowable to the taxpayer as a deduction for interest (within the meaning of § 265(b)(4)) for the taxable year (determined without regard to §§ 264(f), 265(b) and 291).

Section 264(f)(3) defines "unborrowed policy cash value" as, with respect to any life insurance policy or annuity or endowment contract, the excess of (A) the cash surrender value of the policy or contract determined without regard to any surrender charge, over (B) the amount of any loan with respect to the policy or contract. If the amount described in (A) with respect to any policy or contract does not reasonably approximate its actual value, the amount taken into account under (A) is the greater of the amount of the insurance company liability or the insurance company reserve with respect to the policy or contract (as determined for purposes of the annual statement approved by the National Association of Insurance Commissioners) or is another amount as determined by the Secretary.

Section 264(f)(2) states that, for purposes of § 264(f)(1), the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash values is an

amount that bears the same ratio to that interest expense as the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, bears to the sum of (i) in the case of assets of the taxpayer that are life insurance policies or annuity or endowment contracts, the average unborrowed policy cash values of those policies and contracts, and (ii) in the case of any other assets of the taxpayer, the average adjusted bases (within the meaning of § 1016) of those assets.

Section 264(f)(4) provides an exception to the pro rata interest expense disallowance rule of § 264(f)(1) for certain policies and contracts. Under § 264(f)(4), § 264(f)(1) does not apply to any policy or contract owned by an entity engaged in a trade or business if the policy or contract covers only one individual and if that individual is (at the time first covered by the policy or contract) (i) a 20-percent owner of the entity, or (ii) an individual (not described in (i)) who is an officer, director, or employee of the trade or business.

Section 264(f) applies to contracts issued after June 8, 1997, in taxable years ending after that date. For this purpose, any material increase in the death benefit or other material change in the contract is treated as a new contract. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1084.

Section 1035(a)(1) provides that no gain or loss is recognized on the exchange of a life insurance contract for another life insurance contract, or for an endowment or annuity contract or for a qualified long-term care insurance contract. The legislative history of § 1035 explains that § 1035 provides non-recognition treatment for taxpayers

who have "merely exchanged one insurance policy for another better suited to their needs and who have not actually realized gain." H. Rep. 1337, 83d Cong., 2d Sess. 81 (1954). Under § 1.1035-1, the contracts exchanged must relate to the same insured.

ANALYSIS

Old Policy

In both Situation 1 and Situation 2, A was an employee of Taxpayer on January 3, 2000, which was the date as of which A was first covered by Old Policy. A was the only individual covered by Old Policy. Under the exception provided by § 264(f)(4)(A), the pro rata interest expense disallowance rule of § 264(f)(1) did not apply to Old Policy in either situation.

New Policy

In general, a contract that is received in exchange for an existing contract is treated as a new contract issued on the date of the exchange for purposes of testing the contract's qualification as a life insurance contract under § 7702. See 1 Staff of Senate Comm. on Finance, 98th Cong., 2d Sess., Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984, at 579 (Comm. Print 1984); Notice 2006-95, 2006-2 C.B. 848, section 5.01. Consistently, the exchange of a life insurance contract for another life insurance contract is treated as a material change, and the contract received in the exchange is treated as a new contract, for purposes of applying the 7-pay test of § 7702A(b) to determine whether the contract is a modified endowment contract (MEC). 2 H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. II-98 (1988), 1988-3 C.B. 588. Cf. 1 Staff of Senate Comm. on Finance, 98th Cong., 2d

Sess., Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984, at 540 (Comm. Print 1984) (date of issuance of a life insurance contract for purposes of determining the tax reserve method applicable to the contract under § 807(d)(2) is the date shown on the policy form).

In some circumstances, the issue date or other attributes of a contract carry over in a § 1035 exchange pursuant to an explicit rule. For example, in the case of § 101(j) Congress grandfathered an employer-owned life insurance contract that is received after August 17, 2006, in a § 1035 exchange for a contract that was issued on or before that date. Pension Protection Act of 2006, § 863(a), Pub. L. No. 109-280. See also Rev. Rul. 92-95, 1992-2 C.B. 43 (for purposes of § 72(q)(2)(l) and 72(u)(4), the "date of purchase" of an annuity contract acquired in a § 1035 exchange for another annuity contract is the date of purchase of the annuity contract that was exchanged for the new contract). Congress did not provide a rule under which the status of the insured as an employee "at the time first covered" for purposes of § 264(f)(4)(A) would carry over from a contract given up in a § 1035 tax-free exchange to a contract received in such an exchange, even though the status of the insured as an employee is material to the purpose and application of the exception provided by § 264(f)(4).

In Situation 1, A was an employee of Taxpayer on January 3, 2011, which was the date as of which A was first covered by New Policy. A was the only individual covered by New Policy. Under the exception provided by § 264(f)(4)(A), the pro rata interest expense disallowance rule of § 264(f)(1) did not apply to New Policy in Situation 1.

In Situation 2, A was not an employee of Taxpayer on January 3, 2011, which was the date as of which A was first covered by New Policy, nor was A a 20-percent owner, officer, or director of Taxpayer. Accordingly, New Policy does not qualify for the exception provided by § 264(f)(4)(A). The fact that A was an employee of Taxpayer at the time first covered by Old Policy (January 3, 2000) does not change this result.

HOLDINGS

In both Situation 1 and Situation 2, Old Policy qualified for the exception provided by § 264(f)(4). Therefore, the pro rata interest expense disallowance rule of § 264(f)(1) did not apply to Old Policy.

In Situation 1, New Policy qualifies for the exception provided by § 264(f)(4). Therefore, the pro rata interest expense disallowance rule of § 264(f)(1) does not apply to New Policy.

In Situation 2, New Policy does not qualify for the exception provided by § 264(f)(4). Therefore, the pro rata interest expense disallowance rule of § 264(f)(1) applies to New Policy.

DRAFTING INFORMATION

The principal author of this revenue ruling is Rebecca L. Baxter of the Office of Associate Chief Counsel (Financial Institutions & Products). For further information regarding this revenue ruling, contact Ms. Baxter at (202) 622-3970 (not a toll-free call).