



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

September 30, 1999

Number: **199952047**

Release Date: 12/30/1999

CC:DOM:IT&A:5/PLR-116126-98

UILC: 162.04-02

MEMORANDUM FOR

FROM: David L. Crawford  
Chief, CC:DOM:IT&A:5

SUBJECT: Notification of Withdrawal of Request for Ruling

LEGEND:

Taxpayer:  
Insurance Company:

X:

Y:

Year 1:

Year 2:

\$a:

\$b:

\$c:

\$d:

This memorandum and the attached materials are being forwarded to you in accordance with section 8.07(2) of Rev. Proc. 98-1, 1998-1 C.B. 7, 35.

This document is not binding on examination or appeals and is not a final case determination. This document is not to be cited as precedent.

## FACTS

Taxpayer is an S corporation and an import wholesaler of X. In order to attract and retain quality executives, Taxpayer enters into Termination Compensation Agreements (“TCAs”) with selected key employees. In Year 1, Taxpayer entered into TCAs with five key employees, who are all officers of Taxpayer. The TCAs provide that:

- (1) In the event the employee’s employment is terminated, Taxpayer will pay termination compensation equal to the amount of compensation (plus annual bonus compensation amounts, if any) that is being paid to the employee prior to the termination date.
- (2) Payments will not be made if the key employee’s employment is terminated for any of the following reasons:
  - A. Death;
  - B. Disability due to accident or sickness;
  - C. Employee’s voluntary termination;
  - D. Self-inflicted injuries; or
  - E. Negligent or willful misconduct; substance abuse; dishonesty or fraud; insubordination; incompetence or inefficiency; conflict of interest; or breach of employment contract.
- (3) Termination compensation will provide the employee with replacement wages during the period of unemployment limited to a maximum of two years. If the employee finds new employment, but at a lower salary, Taxpayer will pay replacement wages equal to the difference, up to 25% of the employees’ termination compensation, between the new compensation and the former compensation, for the same two year period.
- (4) Taxpayer will assist the employee in finding comparable new employment and will provide employment counseling.

Thus, for example, Taxpayer would be required to make compensation payments if a key employee’s employment were terminated due to Taxpayer’s downsizing or as the result of a merger with another business.

Also in Year 1, Taxpayer purchased from Insurance Company<sup>1</sup> a Loss of Income Insurance (“LOI”) policy on each employee who is a party to a TCA. The LOI policy will reimburse Taxpayer for an amount equal to its obligation to make termination compensation payments to a terminated employee. LOI policy claims are paid in accordance with provisions that are identical to the replacement wage provisions set forth in the TCA. The premiums paid on the LOI policies for each key employee ranged in amount from \$a to \$b for one year of coverage and were due and payable on the policy effective date. If Taxpayer wishes to obtain coverage beyond the one year term, it must purchase a new LOI policy at the end of the previous policy period. Taxpayer is the policy owner and the beneficiary of the LOI policies.

At the time it purchased the LOI policies, Taxpayer also purchased from Insurance Company a separate Return of Premium (“ROP”) rider for each LOI policy. The premiums paid for the ROP riders ranged from \$c to \$d for a one year period of coverage. The ROP rider provides that if no claim is made under the LOI policy during its one-year coverage period, the ROP rider will pay the Taxpayer when the employee reaches age 65 or after 10 years, whichever is greater, an amount equal to 95% of the LOI premium (“premium return amount”) plus accrued earnings on the premium return amount from the date the ROP rider becomes effective. The amount of “accrued earnings” reflects the portfolio values on investments directed by Insurance Company.<sup>2</sup> If the employee dies before reaching age 65 or a period of 10 years, whichever is greater, the premium return amount and the accrued earnings are forfeited.<sup>3</sup>

For federal income tax purposes, Taxpayer deducted in Year 1 the LOI policy premiums and the ROP rider premiums that it paid to Insurance Company. In Year 2, Taxpayer requested a ruling that both the LOI premiums and the ROP premiums are deductible under § 162 of the Internal Revenue Code as ordinary and necessary business expenses. Taxpayer submitted additional information on April 6, 1998, July 26, 1999, and August 16, 1999.

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<sup>1</sup> Insurance Company is an offshore entity located in Y. It is not authorized to do business in the United States.

<sup>2</sup> According to Insurance Company’s promotional materials, however, Taxpayer may be able to direct the investment of the premiums after the first year to mutual funds or other investment vehicles with a higher potential rate of return.

<sup>3</sup> Insurance Company’s promotional materials encourage investors to combine the ROP rider with the purchase of guaranteed-issue, annual renewable term life insurance on the covered employee as a means of insuring the value of the ROP benefit against the risk that the employee will die before the maturity date.

## LAW AND ANALYSIS

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during a taxable year in carrying on any trade or business. Section 1.162-1(a) of the Income Tax Regulations includes among deductible business expenses, insurance premiums against fire, storm, theft, accident or similar losses.

There is no general definition of insurance for tax purposes. It is a well-established principle, however, that all insurance contracts, in order to qualify as such, must involve the shifting of an economic risk of loss away from the insured and the distribution of that risk among the insurance company's other policyholders.

In this case, assuming that a covered termination occurs during the policy period, the value of Insurance Company's obligation to indemnify Taxpayer for monthly compensation payments and employment counseling services provided to key employees could exceed the amount of the "premium" for the LOI policy. Hence, elements of risk shifting and risk distributing are present under the purported insurance transaction. However, we do not believe that a presence of some element of risk shifting and risk distributing necessarily means that the total payments made by Taxpayer to Insurance Company are for insurance coverage. If the "premium" for the LOI policy is disproportionately high relative to the risk of a covered termination event occurring during the policy period, and if the amount that would be received on the maturity of the ROP rider is essentially equivalent to the return that Taxpayer would have earned if the "premium" were placed in an alternative investment arrangement, such as with a bank, a savings and loan, or a mutual fund, then the principal purpose of the LOI policy is not solely for insurance protection. Because the LOI policy and ROP rider "premiums" were not solely for insurance protection, our tentative conclusion is that the "premiums" are not deductible as ordinary and necessary business expenses under § 162.<sup>4</sup>

If you concur with our tentative conclusion that the LOI policy "premium" paid by Taxpayer, or at least some portion of it, represents a non-insurance payment, the question arises as to how the arrangement should be treated for federal tax

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<sup>4</sup> See United Parcel Service of America, Inc. v. Commissioner, T.C. Memo. 1999-268. In UPS, the Tax Court concluded that none of the amounts paid by UPS for "insurance" were deductible under § 162, even though some "theoretical" risk had been transferred. The court specifically discussed the vastly inflated price paid by UPS to its commercial insurer, relative to the remote risk transferred. The court also noted that the entire transaction was a tax motivated sham and that expenses incurred in furtherance of a sham transaction are not deductible.

purposes (other than Taxpayer being denied a deduction under § 162 for the LOI policy and ROP rider “premiums”). The program marketed and sold by Insurance Company recommends that a potential investor purchase three types of insurance, namely: (i) the LOI policy, (ii) the ROP rider, and (iii) a guaranteed-issue annual term life insurance policy.<sup>5</sup> The three policies held in combination provide Taxpayer with a risk-free investment of 95 percent of the LOI policy “premium” (“premium return amount”) along with a guaranteed return equal to accrued earnings on the premium return amount. Thus, the program represents a single investment transaction for federal tax purposes and, as such, arguably constitutes a debt instrument on which Taxpayer must accrue and include in its gross income any original issue discount or other imputed interest income as required by the Internal Revenue Code and Income Tax Regulations. For example, see §§ 1.1272-1, 1.1275-4, and 1.1275-5.

We note, however, that if there is no term life insurance policy to cover the risk of loss arising from the death of an insured employee prior to the ROP rider payout, then a significant contingency exists that may prevent the transaction from being treated as a debt instrument for federal tax purposes. In making this factual determination, it is important to keep in mind that the term life insurance policies may have been purchased by Taxpayer or by the insured employees themselves or by another related party.

Based on our tentative conclusion that the LOI policy and ROP rider “premiums” were not deductible under § 162, we informed Taxpayer that we were tentatively adverse to their ruling request. We held a telephone conference with Taxpayer and its representatives on August 10, 1999. During the conference, we raised a number of questions concerning the ruling request. First, we asked Taxpayer to provide information establishing that the “premium” for the LOI policy represented an actuarially computed premium necessary to cover anticipated losses under the policy, taking into account such factors as the key employees’ employment status, Taxpayer’s prospective earnings during the policy period, and Insurance Company’s loss experience with similar policies. We also asked Taxpayer whether it had taken action to negate the risk that the “premium”

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<sup>5</sup> It is unclear from Taxpayer’s submissions whether term life insurance was purchased on the lives of the covered employees. In its submission dated July 26, 1999, Taxpayer represented that Insurance Company did not issue any term life insurance on Taxpayer’s employees. In its submission dated August 16, 1999, Taxpayer represented that Taxpayer does not own nor maintain policies of life insurance on the lives of any employees covered by the LOI policies. This information, however, does not preclude the possibility that Taxpayer’s employees or another related party may have purchased term life insurance on the lives of Taxpayer’s employees.

payments (and accumulated investment earnings) would not be recovered by purchasing annual term life insurance coverage on the key employees in connection with the purported insurance transaction. Taxpayer's preliminary response was that it had no intention of acquiring life insurance coverage on the key employees. However, we believe that this response does not make economic sense and is at odds with the strategy outlined in Insurance Company's promotional materials.

Taxpayer did not respond to our questions and subsequently requested to withdraw its ruling request. Because Taxpayer withdrew its request after we had formed a tentatively adverse opinion, we are forwarding this information to you for whatever action you deem appropriate.

We have discussed this ruling request with the Industry Specialist for Offshore Compliance/Foreign Trusts. After reviewing the information attached, please contact the Industry Specialist for further assistance. If you have any questions regarding this memorandum, please contact me at (202) 622-4950.

Attachments