Part I

Section 312.—Effect on Earnings and Profits

26 CFR 1.312-6: Earnings and profits.
(Also §§ 101, 264).

Rev. Rul. 2009-25

ISSUE

When is interest that is disallowed as a deduction under § 264(a)(4) of the Internal Revenue Code ("Disallowed Interest") taken into account in determining earnings and profits?

FACTS

A, an individual, holds a paid-up life insurance contract on his own life. Upon the death of A, the death benefit under the contract ($500) is payable to the beneficiary named in the contract.

X is a calendar year subchapter C corporation unrelated to A. On the first day of Year 1, X purchases A's life insurance contract for $100 in a transaction that is not described in § 101(a)(2)(A) or (B), and names itself the beneficiary under the contract.

On the first day of Year 1, X borrows $100 at seven percent simple interest per annum to purchase the life insurance contract. The interest on the loan is unconditionally payable at the end of Year 1 and Year 2 and the interest was in fact paid at the end of Year 1 and Year 2. But for its disallowance under § 264(a)(4), X could deduct seven dollars of interest on the loan in both Year 1 and Year 2 under § 163. Other than the initial purchase price, the interest on the loan is the only amount X incurs in connection with the contract.

A dies on the first day of Year 3, and X receives the $500 death benefit under the life insurance contract. Pursuant to § 101(a)(2), X includes $386 in gross income ($500 (death benefit) - ($100 (amount paid for the contract) + $14 (Disallowed Interest deductions in Year 1 and Year 2))).

LAW AND ANALYSIS

Section 101(a)(1) provides that except as otherwise provided in §§ 101(a)(2), 101(d), 101(f), and 101(j), gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.

Section 101(a)(2) generally provides that in the case of a transfer for valuable consideration, by assignment or otherwise, of a life insurance contract or any interest therein, the amount excluded from gross income by § 101(a)(1) shall not exceed an amount equal to the sum of the actual value of such consideration and the premiums and “other amounts” subsequently paid by the transferee. The term "other amounts" includes interest paid or accrued by the transferee on indebtedness with respect to the contract or any interest therein if such interest paid or accrued is not allowable as a deduction by reason of § 264(a)(4).

Section 163(a) generally provides that a deduction is allowed for all interest paid or accrued within the taxable year on indebtedness.

Section 264(a)(4) generally provides that no deduction shall be allowed for any interest paid or accrued on any indebtedness with respect to 1 or more life insurance policies owned by the taxpayer covering the life of any individual, or any endowment or annuity contracts owned by the taxpayer covering any individual.

Earnings and profits are a measure of economic income, or a corporation's capacity to pay dividends. See e.g., S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess., 198 (1984). "In general, the computation of earnings and profits of a corporation . . . is based upon reasonable accounting concepts that take into account the economic realities of corporate transactions as well as those resulting from the application of tax law. Thus, losses and expenses that are disallowed as a deduction for Federal income tax purposes, charitable contributions in excess of the limitation provided therefore [sic], and other items that have actually depleted the assets of the corporation, even though not reflected in the income computations, are allowed as deductions in computing earnings and profits." Rev. Rul. 75-515, 1975-2 C.B. 117, obsoleted by Rev. Rul. 2003-99, 2003-2 C.B. 388 (holding codified in § 312(l)). See also Rev. Rul. 71-165, 1971-1 C.B. 111 ("An expense of an accrual basis corporation that under the Code is never an allowable deduction in computing taxable income usually is reflected in earnings and profits in the year to which it is attributable, except where the Code specifically provides that the corporation's earnings and profits shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income."); Rev. Rul. 77-442,1977-2 C.B. 264 (quoting Rev. Rul. 71-165 and Rev. Rul. 75-515). Because Disallowed Interest depletes the assets of a corporation at the time the interest would be allowed as a deduction but for its disallowance under § 264(a)(4), earnings and profits are also reduced in that year. Accordingly, X in both Year 1 and Year 2 reduces its earnings and profits by the seven dollars of Disallowed Interest.

In Year 3, X receives the $500 death benefit under the life insurance contract purchased from A and, under § 101(a)(2), excludes from gross income an amount representing the $14 of Disallowed Interest.

Items excluded from gross income generally increase earnings and profits. See § 1.312-6(b). Furthermore, even though the Disallowed Interest in Year 1 and Year 2 actually depletes the amount of earnings available for distribution, X previously reduced its earnings and profits by the Disallowed Interest in each of those years. Section 1.312-6(d) ("A loss sustained for a year before the taxable year does not affect the earnings and profits of the taxable year."); Rev. Rul. 76-299, 1976-2 C.B. 211 ("A capital loss carryover does not affect the earnings and profits of the taxable year in which it is used because the loss giving rise to the carryover is reflected in the accumulated earnings and profits at the beginning of the taxable year of the carryover"). Reducing earnings and profits in Year 3 by the amount of Disallowed Interest taken into account under § 101(a)(2) would cause an unwarranted double reduction of earnings and profits and, therefore, is not permitted. See, e.g., Bangor & Aroostook Railroad Co. v. Commissioner, 16 T.C. 578, 586 (1951), aff'd 193 F.2d 827 (1^{st} Cir. 1951).

Although X in Year 3 includes in its gross income only $386 of the $500 death benefit because of the applicable offsets under § 101(a)(2) (including the $14 of Disallowed Interest), X includes $400 ($500 (the death benefit) less $100 (the amount X pays for the contract)) in its earnings and profits in Year 3.

HOLDING

Disallowed Interest under § 264(a)(4) reduces earnings and profits for the taxable year in which the interest would have been allowable as a deduction but for its disallowance under § 264(a)(4). It does not further reduce earnings and profits when the death benefit is received under a life insurance contract.

DRAFTING INFORMATION

The principal author of this revenue ruling is Russell P. Subin of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Russell P. Subin at (202) 622-7790 (not a toll-free call).