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Date:
May 03, 2007

Dear :

This is in response to the letter from your representative dated November 22, 2006 requesting a ruling concerning subchapter L of chapter 1 of the Internal Revenue Code.

FACTS

Taxpayer represents as follows:

Taxpayer is a corporation that qualifies as an insurance company for purposes of the Code. Whether Taxpayer is subject to tax under part I or part II of subchapter L depends on whether, for the taxable year in question, Taxpayer satisfies the definition of a life insurance company in § 816(a). For business reasons, Taxpayer proposes to purchase, from an insurance company not affiliated with Taxpayer, certain life insurance policies of a type having cash value, covering the lives of Taxpayer's officers. Taxpayer will be the owner of, and pay all premiums due under, these policies. Taxpayer will be the sole beneficiary of all of these policies. The goal of this purchase is to provide funds to deal with premature deaths of Taxpayer's officers, to fund some of Taxpayer's long term obligations, and to provide reasonable investment returns.

RULINGS REQUESTED

Taxpayer requests a ruling that the references to § 264(f) in §§ 807(a)(2)(B), 807(b)(1)(B) and 832(b)(5)(B)(iii) take into account the exceptions to the application of the interest disallowance rule of § 264(f).

LAW AND ANALYSIS

The contracts Taxpayer proposes to acquire are life insurance contracts for federal income tax purposes. Therefore, the annual increases in the cash value of such contracts will not be currently included in Taxpayer's taxable income. See § 7702(g). Amounts Taxpayer receives by reason of the death of the insured(s) may be excluded from gross income. See § 101(j).

In computing the taxable income of a life insurance company, §§ 807(a)(2)(B) and 807(b)(1)(B) require certain items to be adjusted by "the amount of the policyholders' share of tax-exempt interest and the amount of the policyholders' share of the increase for the taxable year in policy cash values (within the meaning of § 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which § 264(f) applies." Similarly, in computing the taxable income of an insurance company other than a life insurance company, § 832(b)(5)(B)(iii) requires the amount of losses incurred to be reduced by an amount equal to 15 percent of, among other things, "the increase for the taxably year in policy cash values (within the meaning of § 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which § 264(f) applies." Hence, the computation of reserves of both a life insurance company and an insurance company other than a life insurance company are determined by rules which reference "contracts to which § 264(f) applies."

These references to § 264(f) in subchapter L were added by § 1084(c) of the Taxpayer Relief Act of 1997, 1997-4 (Vol. 1) C.B. 1, 166-69. Section 264(f)(1) provides that "[n]o deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to unborrowed policy cash value." Section 264(f)(4) identifies those policies and contracts which are excepted from the rule of § 264(f)(1). Section 264(f)(8)(B) provides that §264(f) "shall not apply to an insurance company subject to tax under subchapter L".

The Conference Report accompanying the bill that included § 264(f) indicates that the conference agreement followed the House bill and the Senate amendment, with modifications. H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 588 (1997), 1997-4 (Vol. 2) C.B. 2058. The reports of both the House Committee on the Budget and the Senate Committee on Finance indicate that the provision focused on deductions for interest on debt with respect to cash value life insurance purchased by institutions on the lives of their debtors, citing examples such as a business buying cash value life insurance on the lives of its debtors and increasing that investment even as the debt is repaid, a mortgage lender doing likewise even as the underlying loan was sold or pooled, and a buyer of such a loan taking out a second similar policy on the same debtor. Moreover, "[the law prior to § 264(f)] was not intended to promote tax arbitrage by allowing financial or other business that have the ongoing ability to borrow funds from depositors, bondholders, investors, or other lenders to concurrently invest a portion of their assets in cash value life insurance contracts, or endowment or annuity contracts." H. R. Rep.

No. 148, 105th Cong., 1st Sess. 501 (1997); S. Rep. No. 33, 105th Cong., 1st Sess. 186-87 (1997).

The Congress addressed this problem by, among other things, imposing a pro rata disallowance rule on interest on debt to fund life insurance. Where applicable this rule provides that “no deduction is allowed for the portion of the taxpayer’s interest expense that is allocable to the unborrowed policy cash surrender values with respect to any life insurance policy or annuity or endowment contract issued after June 8, 1997.” H. R. Rep. No. 148, at 502; S. Rep. No. 33, at 187. This rule was not intended to “apply to any policy or contract owned by an entity engaged in a trade or business, covering any individual who is an employee, officer, or director of the trade or business at the time first covered by the policy or contract.” H. R. Rep. No. 148, at 502; S. Rep. No. 33, at 188.

In the case of insurance companies, though, “the provision does not apply …[r]ather, the rules reducing certain deductions for losses incurred … and reducing reserve deductions or dividends received deductions … are modified to take into account the increase in the cash values of life insurance policies or annuity or endowment contracts held by insurance companies.” H. Rep. No. 148, at 503; S. Rep. No. 33, at 188. These modifications were effected by additions to the sentences describing the rules applicable tax-exempt interest. For example, where §§ 807(a)(2)(B) and (b)(1)(B) previously read “the sum of (i) the amount of the policyholders’ share of tax-exempt interest, plus (ii) any excess described in § 809(a)(2) for the taxable year”, the sections now read “the amount of the policyholders’ share of tax-exempt interest and the amount of the policyholders’ share of the increase for the taxable year in policy cash values (within the meaning of § 805(a)(4)(F)) of life insurance policies and annuity and endowment contracts to which § 264(f) applies”. This strongly suggests that these references to § 264(f) should be read *in pari materia* with the pre-existing portion of the sentences.

Rules applicable to a life insurance company (Part I of Subchapter L)

The rules for computing the taxable income of a life insurance company were overhauled by the Tax Reform Act of 1984,[1] § 201 et seq., 1984-3 (Vol. 1) C.B. 228-75. The Conference Report observed that the taxation of life insurance companies prior to the 1984 overhaul included a “proration formula” to allocate investment yield between the policyholders and the company. “The practical effect of the proration formula is to treat additions to reserves as funded in part out of tax-exempt income thus limiting the tax benefit a company can enjoy by the receipt of tax-exempt income.” H.R. Conf. Rep. No. 861, 98th Cong., 2nd Sess. 1065 (1984), 1984-3 (Vol. 2) C.B. 319. The 1984 overhaul retained this general concept. Id.

[1] The Tax Reform Act of 1984 was Division A of the Deficit Reduction Act of 1984.

As originally enacted, § 805(a)(4)(C) described "100 percent dividend" as a term that "does not include any dividend to the extent it is a distribution out of tax-exempt interest or out of dividends which are not 100 percent dividends". Sections 807(a)(2)(B) and (b)(1)(B) originally required a reduction in the yearly closing balance of reserves by "the amount of the policyholders' share of tax-exempt interest". And for purposes of allocating investment income between the company and its policyholders, § 812(d)(1)(A) originally spoke of "interest (including tax-exempt interest)."

Explaining the operation of § 812, the House Ways and Means Committee observed that

> Because reserve increases might be viewed as being funded proportionately out of taxable and tax-exempt income, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest. Similarly, a life insurance company is allowed a dividends-received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends. 100 percent dividends from affiliates are excluded from application of the proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be 100 percent deductible if received directly by the taxpayer.

H. R. Rep. No. 432, 98th Cong., 2nd Sess. pt 2, 1431 (1984). With respect to the treatment of dividends received, the Report notes that

> to the extent these earnings are distributions of tax-exempt income, they have not been taxed and should be subject to proration. Without this rule, a parent life insurance company could avoid proration of tax-exempt interest by having a subsidiary own all of its tax-exempt obligations. The subsidiary would not be taxed on this income which it could distribute to the parent as dividends. However, the proposed rule would avoid this result by having gross investment income include dividends received from a subsidiary to the extent that such dividends are distributions of tax-exempt interest or of dividend income that would not be 100 percent deductible if received directly by the taxpayer. … [T]he proration of tax-exempt income may also be avoided by distributing surplus in the form of dividends to a parent (nonlife insurance) company that could invest in tax-exempt income. This possibility is less troublesome than that of placing assets in a subsidiary because assets of a parent do

> not contribute to a company's surplus while assets of a subsidiary do. This effectively places a limitation on the amount of assets which a company may pay as dividends to a parent without jeopardizing its ability to do business under State law.

Id., at 1406-07.

Accordingly, the rules applicable to a life insurance company after the 1984 overhaul required segregating tax-exempt income into the shares allocable to the company and to policyholders and adjusting the allowed reserves to preclude funding those reserves with the policyholders' share.

Rules applicable to an insurance company other than a life insurance company (Part II of Subchapter L)

The rules for computing the taxable income of an insurance company other than a life insurance company have been in effect without substantial modification for many decades. For purposes of this analysis, the focus can be put initially on the effect of the Tax Reform Act of 1986, § 1022, 1986-3 (Vol. 1) C.B. 314-16. This Act amended § 832(b)(5)(B) to require the deduction for losses incurred to be reduced by 15 percent of the sum of tax-exempt interest received or accrued and dividends received. Explaining this provision, the Conference Report noted that under prior law,

> [n]o reduction in the loss reserve deduction is required … to take account of the fact that deductible additions to reserves may come out of income not subject to tax. Unlike life insurance companies, property and casualty insurance companies are not required to allocate or prorate investment income (including tax-exempt investment income) so as to take account of the possibility of a double deduction were deductible additions to reserves are funded with tax-exempt income (or with the deductible portion of dividends received.)

2 H.R. Rep. No. 841, 99th Cong., 2nd Sess. II-356 (1986), 1986-3 (Vol. 4) C.B. 356.

The underlying House report goes into more detail for purposes of explanation. It notes the proration rule applicable to life insurance companies responds to "the assumption that reserve increases are being funded out of both taxable and tax-exempt income." H. R. Rep. No. 426, 99th Cong., 1st Sess. 670 (1985). The House committee "believe[d] it [was] not appropriate to fund loss reserves on a fully deductible basis out of income which may be, in whole or in part, exempt from tax." Therefore, "[t]he amount of the addition to reserves that is deductible should be reduced by a portion of such tax-exempt income to reflect the fact that reserves are generally funded in part from tax-exempt interest or from wholly or partially deductible dividends." Hence a proration-like provision was applied to the computation of the deductible reserve of an insurance company other than a life insurance company. Id.

Scope of contracts to which § 264(f) applies

The modifications of the subchapter L rules regarding deductible reserves reference contracts to which § 264(f) applies. Section 264(f), including the subchapter L modifications, was enacted as §1084 of the Taxpayer Relief Act of 1997. Section 1084(d) provides that "[t]he amendments made by this section shall apply to contracts issued after June 8, 1997, in taxable years ending after such date." 1997-4 (Vol. 1) C.B. 169. As codified, § 264(f) does not succinctly describe the contracts to which it applies; § 264(f)(2)(A) speaks of the unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997. Though § 264(f)(4) carves out contracts covering owners, officers, directors, and employees, as well as contracts subject to § 72(u), it does so only by removing such contracts from the operation of § 264(f)(1) ("Paragraph (1) shall not apply…"), not necessarily the entire subsection. And while these contracts are carved out of § 264(f)(1), § 264(f)(4)(C) nonetheless operates on these contracts for purposes of determining the remaining interest expense subject to the rule by requiring the contracts to be excepted from the denominator of the allocation ratio under § 264(f)(2)(B).

Summation

The import of §§ 807(a)(2)(B), 807(b)(1)(B), and 832(b)(5)(B)(iii) is to prorate an insurance company's investment income to preclude the funding of deductible reserves with tax-exempt income. In addition to interest and deductible dividends received, the annual increase in the cash value of a life insurance contract (ultimately leading to an excludable death benefit) is tax-exempt. To include this additional source of tax-exempt income within the purview of these proration rules, Congress modified the practical application of these rules by incorporating a reference to contracts subject to § 264(f). Contracts such as those Taxpayer proposes to acquire are "contracts to which § 264(f) applies" because they will be issued after June 8, 1997 even though § 264(f)(4)(A) removes them from the disallowance rule of § 264(f)(1). Life insurance companies are actually advantaged by this because § 264(f)(8)(B) excepts insurance companies from the operation of § 264(f)(1); for example, although § 807 requires an adjustment to reserves to reflect the policyholders' share, it does not require an adjustment to reflect the company's share, which is not subject to the § 264(f)(1) disallowance rule.[2]

<u>Ruling</u>

[2] Insurance companies other than life insurance companies do not have a "company's share" excepted from the § 264(f)(1) rule. Nonetheless, because § 832(b)(5)(B) requires a reduction equal to 15 percent of the increase in the policy value during the taxable year, it may be that these insurance companies are not significantly disadvantaged vis a vis life insurance companies or non insurance companies.

The references to § 264(f) in §§ 807(a)(2)(B), 807(b)(1)(B), and 832(b)(5)(B)(iii) do not take into account the exceptions to the application of the interest disallowance rule of § 264(f).

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to Taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to Taxpayer's authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, for a return(s) filed electronically this requirement is satisfied by attaching a statement to the return(s) that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Donald J. Drees, Jr.
Senior Technician Reviewer
Branch 4