Office of Chief Counsel
Internal Revenue Service
Memorandum

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to:

(Large & Mid-Size Business)

from: Christopher F. Kane
Branch Chief, Branch 3
(Income Tax & Accounting)

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subject:

This Chief Counsel Advice responds to your request for assistance dated . This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Club/Employer =

A =

Player/Employee =

Insurance Co. =

Year S =

Year T =

Year U =

Year V =

Year W =

Year X =

Year Y =

Year Z =

$B =

$C =

$D =

$E =

ISSUES

Whether Taxpayer: (1) may exclude from gross income under section 104(a)(3) of the Internal Revenue Code $C in proceeds received under a disability insurance policy related to an injured employee; and (2) take a section 162 deduction for $C in payments made to this injured employee pursuant to an employment contract; or (3) whether the deduction is precluded by section 265.

CONCLUSIONS

The Taxpayer (1) may exclude $C in proceeds received under a disability insurance policy related to an injured employee under section 104(a)(3); and (2) may not take a deduction because the insurance payment is a reimbursement for an expense under section 162; or (3) may be precluded from taking a deduction because the insurance payment is tax exempt income and section 265(1) disallows a deduction allocable to exempt income.

FACTS

For Year X Club was a member of the consolidated group headed by Taxpayer. Club employs Player.

In Year T Player was transferred to Club. Prior to this, Player had been employed by A. Player entered into an employment contract with A in Year S (the employment contract or contract). Player's employment contract was for

multiple years (Year S through Year Y), and included an option for the Year Z. When Player was transferred to Club, Club assumed the liability under this contract. The contract indicates that the base salary for the Year X was $D. The terms of the contract guaranteed this base salary even in the event of injury. The contract states:

Employment Contract, .

An addendum to the employment contract also contains the following language:

Addendum II to Employment Contract).

In Year S, a disability insurance policy on Player was executed between Insurance Co. and A. When Player was transferred to Club, this insurance policy was transferred to Club, which assumed the liability to make premium payments and became the beneficiary of the policy. According to the policy, the participating organization (i.e., Club) was required to pay premiums under the policy.

In Year W, Player was injured and Club began receiving benefits under its insurance policy. In Year X, Player remained injured. During Year X, Club received proceeds totaling $C under the disability insurance policy. Club paid disability insurance premiums totaling $B during Year X for the disability insurance policy. These premium amounts were not included in Player's income during Year X. For tax purposes, Taxpayer considers the premiums to be non-deductible under section 265. Notwithstanding his injury during Year X, Player received payments from Club totaling $E under his employment contract.

LAW AND ANALYSIS

Issue (1): Whether Taxpayer may exclude from gross income under section 104(a)(3) $C in proceeds received under the disability insurance policy related to Player's injury.

Section 104(a)(3) provides in relevant part, that, "Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness…"

The issue presented in this case is identical to the issue addressed in Rev. Rul. 66-262, 1966-2 C.B. 105. In Rev. Rul. 66-262, the taxpayer was a professional baseball club that carried disability policies to protect itself against the accidental disability or death of any of its players, its coaches, and manager. The club was the beneficiary under these policies. The ruling concludes that since section 104(a)(3) provides an exclusion from income for amounts received through accident and health insurance for personal injuries or sickness, the disability insurance premiums are not deductible by the club under section 265 of the Code, which provides that a deduction is

not allowed for any expense which is allocable to exempt income. The ruling also notes that section 104(a)(3) applies to both employer corporations as well as individual employees. See also, Castner Garage, Ltd. v. Commissioner, 43 B.T.A. 1 (1940) (addressing a predecessor section to 104(a)(3) and finding that the exemption for amounts received through accident and health insurance for personal injury or sickness is not limited to individuals, but extends to corporations which have an insurable interest).

The Service argued for the application of Rev. Rul. 66-262 in Rugby Productions LTD v. Commissioner, 100 T.C. 531 (1993). In Rugby, a personal service company was designated as the beneficiary of a disability policy on the company's key employee. The company argued that, although it was listed as the beneficiary under the disability policy, it was the intention of the company's officers, accountants and insurance agents that any proceeds received under the policy would be paid over to the key employee and not retained by the company. The Tax Court found, however, that the key employee's legal right to the proceeds had not been established because the "policy by its terms" was payable to the corporation. The Court noted that notwithstanding the company's intent to pay over to the employee any proceeds received under the disability policy, nothing would have prevented the company from applying the proceeds to third-party claims. The Tax Court agreed with the Service's argument for the application of Rev. Rul. 66-262, and ruled that the proceeds would have constituted exempt income to the company under section 104(a)(3) and since the premiums paid by the corporation were allocable to such income they were nondeductible under section 265(a)(1).

The facts and issue in Peoples Finance & Thrift Co. v. Commissioner, 12 T.C. 1052 (1949) are significantly different from the facts and issue presented in the case at issue. In Peoples, the beneficiary of the insurance policy was indebted to a corporation. The corporation acquired its original interest in the policy by assignment to it as a creditor seeking security for the repayment of the indebtedness of the insured. The corporation subsequently purchased the beneficiary's insurance policy and held it as an investment. The Tax Court held that the exclusion for accident and health proceeds under section 22(b)(5) (the predecessor section to 104(a)(3)) did not extend to purchasers for value. Rather, as the Court stated, the exclusion is intended to apply "only to beneficiaries who suffer an otherwise uncompensated loss as the direct result of the sickness or injury of an insured in whom they have an insurance interest." In Peoples, the corporation was receiving the disability amounts not as compensation for the beneficiary's injuries, but rather as compensation for the beneficiary's unpaid indebtedness.

Taxpayer in the case at issue is not a purchaser for value of the disability policy covering Player. Thus, Peoples is not relevant. Rather, the issue presented in this case is subject to Rev. Rul. 66-262 and Rugby. Here, as in the ruling and in Rugby, the named beneficiary of the disability policy is Club and not Player. Also, like the

employee in Rugby, Player does not have a legal right to the proceeds payable under the policy. Indeed, his employment agreement with Club specifically provides that:

Accordingly, based on the Service's published position, the proceeds received by the Taxpayer are excludable from its income under section 104(a)(3).

Issue (2): Whether Taxpayer may take a section 162 deduction for $C in payments made to Player pursuant to the employment contract.

Section 162(a) provides that a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. See also Treas. Reg. section 1.162-1(a).

Section 1.162-7 of the Income Tax Regulations provides that there may be included among the ordinary and necessary expenses paid or incurred in carrying on a trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 1.162-10(a), however, specifically, limits the deduction for amounts paid or accrued as compensation for injuries to the amount not compensated for by insurance or otherwise. Section 1.162-10(a) provides that amounts paid or accrued by a taxpayer on account of injuries received by employees and lump-sum amounts paid or accrued as compensation for injuries are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational welfare, or similar benefit plan are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business.

Section 162 does not address whether or when insurance recoveries or the prospect of insurance recoveries prevent a taxpayer from deducting expenses that are otherwise deductible under that section.

A deduction for an expense for which there is a right or expectation of reimbursement may be disallowed on the grounds that the payments are not expenses of the taxpayer. The extent to which the right must be established has varied. Some cases have denied the deduction because the right of reimbursement was fixed, others have allowed the deduction because the right of reimbursement was uncertain, and

other cases have denied the deduction even if the taxpayer's right to reimbursement was subject to a contingency.

A fixed or established right of reimbursement precludes a taxpayer from deducting expenses that would otherwise be deductible under section 162. Rev. Rul. 79-263, 1979-2 C.B. 82 (no deduction for portion of expenses for which the taxpayer knows he will be reimbursed since the taxpayer suffers no economic detriment with respect to these expenses). A right to reimbursement is sufficiently fixed to preclude a deduction when the right has matured without further substantial contingency. Charles Baloian Company, Inc. v. Commissioner, 68 T.C. 620, 626, 628 (1977), nonacq. on other grounds, 1978-2 C.B. 3. A fixed right of reimbursement has been shown through written agreements specifically providing that the taxpayers' expenses were to be reimbursed or written statements from a third party authorizing the taxpayer to incur the expenses. See Manocchio v. Commissioner, 78 T.C. 989 (1982); Glendinning, McLeish & Co. v. Commissioner, 61 F.2d 950, 952 (2d Cir. 1932); Webbe v. Commissioner, T.C. Memo. 1987-426, aff'd, 902 F.2d 688 (8th Cir. 1990); Rev. Rul. 78-388, 1978-2 C.B. 110 (a taxpayer's moving expenses for which the taxpayer has a fixed right of reimbursement are not deductible under section 162 or section 165).

In Levy v. Commissioner, 212 F.2d 552 (5th Cir. 1954), the taxpayer paid for roof repairs to a building the taxpayer rented for business purposes. After questioning the high cost of the repairs the owner nonetheless agreed to pay and requested that the bills be forwarded. The taxpayer instead paid for additional repairs and notified the owner, but received no reimbursement. The court held that the taxpayer was not entitled to deduct the cost of the repairs as an ordinary and necessary business expense because the taxpayer had a right to reimbursement, despite the owner's ultimate failure to reimburse.

If the right to reimbursement is not fixed, the deduction may be allowed. See George K. Herman Chevrolet, Inc. v. Commissioner, 39 T.C. 846, 853 (1963) (taxpayer had no right to reimbursement at the time the expenses were incurred); Alleghany Corp. v. Commissioner, 28 T.C. 298, 305 (1957), acq., 1957-2 C.B. 3 (deduction not precluded by contingent possibility of future reimbursement from assets of debtor of legal fees and costs for representation in bankruptcy proceeding). In Electric Tachometer Corporation v. Commissioner, 37 T.C. 158, 161-162 (1961), acq., 1962-2 C.B. 4, the taxpayer was allowed a deduction in the year expenses were paid for moving machinery as the result of a condemnation action because there was no fixed right of reimbursement but only an indefinite and general right to recover its expenses. The court concluded that, although the taxpayer had a general right to reimbursement of moving expenses, conflicting evidence at hearings to determine the amount of compensation indicated the lack of definiteness of the taxpayer's right. In Varied Investments, Inc. v. United States, 31 F.3d 651, 653 (8th Cir. 1994), a taxpayer was allowed a deduction under section 162 in the taxable year it transferred money to a trust to provide for the satisfaction of a judgment after three insurers denied liability, even though the taxpayer recovered some insurance proceeds in subsequent years.

An expectation of reimbursement, rather than a fixed and absolute right of reimbursement, has been held to be sufficient to preclude a deduction under section 162. Rev. Rul. 80-348, 1980-2 C.B. 31, holds that travel expenses that otherwise would be allowable as a deduction under section 162(a) may not be deducted if there is an expectation of reimbursement, even if the reimbursement is not received until a later year.

A line of cases has held that an attorney representing clients on a contingent fee basis may not deduct advances to or expenses paid on behalf of the clients as ordinary and necessary business expenses. The amounts were to be repaid from any recovery and although, generally, the taxpayers screened cases they accepted to maximize recoveries, the taxpayers never recovered 100% of the expenditures. Burnett v. Commissioner, 356 F.2d 755, 760 (5th Cir.), cert. denied, 385 U.S. 832, 87 S. Ct. 77, 17 L. Ed. 2d 68 (1966); Herrick v. Commissioner, 63 T.C. 562, 567, 568 (1975); Canelo v. Commissioner, 53 T.C. 217, 225 (1969), aff'd, 447 F.2d 484 (9th Cir. 1971), acq. 1971-2 C.B. 2, nonacq. in part, 1982-2 C.B. 2; Silverton v. Commissioner, T.C. Memo. 1977-198, aff'd, 647 F.2d 172 (9th Cir.), cert. denied, 454 U.S. 1033, 102 S. Ct. 571, 70 L. Ed. 2d 477 (1981); Watts v. Commissioner, T.C. Memo. 1968-183. In Flower v. Commissioner, 61 T.C. 140, 152 (1973), aff'd, 505 F.2d 1302 (5th Cir. 1974), which involved a fixed right to reimbursement, the court characterized Burnett as holding that even a contingent right to reimbursement is sufficient to disallow a deduction. Based on these authorities, we conclude that a right of reimbursement precludes a deduction for a business expense under section 162 even if there is not a certainty of reimbursement. A mere possibility of reimbursement does not preclude a deduction. In most cases, if the taxpayer has an insurance policy that, on its face, covers the item in question, and there is no indication that an exception to coverage applies, then a deduction under section 162 should be disallowed, as the taxpayer would have a fixed contractual right to reimbursement.

The facts in this case demonstrate a close nexus between the taxpayer's right to receive proceeds under the disability insurance policy and the employment contract with Player. The Club entered into the employment contract with Player with the anticipation that if the Player was injured the disability insurance policy would cover the Club for its potential liability with respect to payment obligations to Player. The employment contract specifies that the Club's obligation to pay the Player is

Thus, the Taxpayer entered into the employment contract with Player with the anticipation that it would be reimbursed for its potential liability with respect to the payment obligations made to Player by the disability insurance policy.

The right to reimbursement under section 162 is highly factual. A deduction for an expense under section 162 may be denied if, based on the facts and circumstances, the taxpayer has insurance coverage that appears to provide a right to reimbursement and there is no indication that an exception to coverage applies. Additional factual information regarding the insurance claim, such as correspondence from the Insurance Co. itself regarding the claim, the past history of similar insurance claims, standard industry practice regarding such claims, as well as information used to determine the amount of the payments to be made under the insurance contract may all be useful to assist in further establishing the connection between the insurance policy and the employment contract.

In this case the Employer certainly had an expectation of reimbursement for Year X. The employment contract and the disability insurance contract had been in place since Year S and Employer had been collecting under the disability policy for several years. Employer knew the exact amounts it would receive under the policy as well as the exact amounts it would pay to Employee under the Employment contract. The disability insurance contract was taken out to cover the exact circumstances under which Employer found itself in Year X. The fact that the insurance policy pays the Club benefits upon the disability of a player rather than pays salary reimbursement benefits is not a meaningful distinction. The employment contract between Player and Club specifically provides for a continuation of salary payments even though Player suffers a disability. (Employment Contract -). Both the insurance policy and the employment contract pay upon disability.

Issue (3): Whether the deduction is denied due to the application of section 265(l), which disallows deductions which are allocable to exempt income.

Section 265(1) provides that an expense amount cannot be deducted if it is “allocable to” a class of tax-exempt income other than interest.

Section 1.165-1(b)(1) provides that a class of tax-exempt income includes any class of income wholly excluded from gross income under any provision of subtitle A of the Code or under the provisions of any other law.

Case law has established a rule that in order for a deduction to be denied under section 265(l), there must be a "[n]exus between the reimbursement income [tax-exempt income] and the expense" in order to establish that the expenses are "allocable to" to the exempt income. Manocchio v. Commissioner, 78 T.C. 989, 995 (1982).

In Manocchio, taxpayer (a veteran) incurred flight training expenses which ordinarily would have been deductible under section 162. However, the taxpayer also received a nontaxable reimbursement from the Veteran's Administration (VA) for these expenses, based on a percentage of the flight training expenses taxpayer incurred. The Tax Court held that the reimbursed expenses were allocable to the tax-exempt income (the reimbursement) and therefore were nondeductible under section 265(l). The Ninth Circuit affirmed Manocchio, but on different grounds. Manocchio v. Commissioner, 710 F.2d 1400 (9th Cir. 1983).

In the case at issue, Club's right to receive proceeds under the disability insurance was tied to the employment contract with Player. It is certainly arguable that Club acquired the disability policy to recover losses it would incur under the employment contract in the event of Player's disability. As a result, the $C in tax-exempt proceeds taxpayer received under the insurance policy arguably constitutes a direct reimbursement of the $E that Taxpayer seeks to deduct. As a result, consistent with the court's opinion in Manocchio, $C of the total $E amount Taxpayer seeks to deduct is not deductible under section 265(1) because it is an expense allocable to the $C in exempt income Taxpayer received.

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Please call us at (202) 622-4950 if you have any further questions.