Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **202053010**
Release Date: 12/31/2020

CC:ITA:B03:JWilliford
POSTF-109608-20

UILC: 162.00-00, 162.27-00, 212.00-00

date: September 16, 2020

to: Kimberly B. Tyson
General Attorney
(Large Business & International)

from: Brinton T. Warren
Branch Chief
(Income Tax & Accounting)

---

subject:

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

LEGEND

Taxpayer	=
Date 1	=
Member	=
Location	=
Date 2	=
Date 3	=
Conservancy	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
$a	=
$b	=

ISSUES

Whether Taxpayer may deduct a " Policy"[1] ("Policy") premium under sections 162(a) or 212 of the Internal Revenue Code ("Code").[2]

CONCLUSIONS

The premium paid toward the Policy is not directly or proximately connected to any trade, business, or income producing activity of Taxpayer. As a result, the premium is not deductible under sections 162(a) or 212(1)–(2). Further, the premium, as part of a contractual arrangement to pay non-deductible tax, is not deductible under section 212(3).

STATEMENT OF FACTS

On Date 1, Member began circulating a private placement memorandum ("PPM") to potential investors. The PPM promoted an opportunity to invest in Member. Member's purpose, as described in the PPM, was to acquire a membership interest in Taxpayer, the soon-to-be owner of certain real property in Location ("Property"). The PPM contemplated three possible uses for the Property: developing it , holding it for investment, or conserving it.

Describing the conservation option as the PPM stated

The PPM noted that the Property was

The PPM also noted that Taxpayer might purchase a " policy" in connection with the donation of a conservation easement. According to the PPM, the purpose of this arrangement would be to

---

[1] Whether the Policy constitutes insurance for federal income tax purposes is beyond the scope of this advice. As used in this advice terms such as "insurance," "policy," and "premium" are for economy and not a suggestion that the Policy is insurance for federal income tax purposes.

[2] Whether Taxpayer is a bona fide partnership or whether its partners are bona fide partners are beyond the scope of this advice, as is the substance of Taxpayer and its transactions under judicial doctrines.

On Date 2, following a series of transactions, Taxpayer acquired the Property and Member acquired a % membership interest in Taxpayer. At that point, Member became Taxpayer’s manager and tax matters partner.

On Date 3, Taxpayer conveyed a conservation easement encumbering the Property to Conservancy. The deed of conservation easement reserved to Taxpayer rights that generally reflected the uses identified in the PPM as possible under a conservation easement, including:

On Date 4, Taxpayer received confirmation of the Policy as contemplated in the PPM. The Policy had a term of Date 5, to Date 6, and defined “loss” as follows:

With respect to defending or settling any proceedings implicating the Policy (defined to include actions brought by a taxing authority concerning the tax treatment of a conservation easement), the Policy states:

Moreover, the costs of investigating, defending, responding to, or appealing any such proceeding are explicitly excluded from the Policy's definition of "loss."

The Policy's named insured is Taxpayer. An endorsement to the Policy, however, adds Member and its investors to those definitionally insured under the Policy.

On Date 7, Taxpayer filed its federal tax return. The return reflected a charitable contribution deduction in the amount of $a and other deductions in the amount of $b; a portion of the latter appears to reflect a premium expense incurred in relation to the Policy.

LAW AND ANALYSIS

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during a taxable year in carrying on any trade or business. Section 212(1)–(2) allows individuals to deduct ordinary and necessary expenses paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. Section 212(3) allows the deduction of expenses related to the determination, collection, or refund of any tax.

Given that the deductibility of Taxpayer's Policy premium is, as explained below, determinable regardless of whether Taxpayer engaged in a trade, business, or income-producing activity, issues relating to Taxpayer engaging in a trade, business, or income-producing activity are beyond the scope of this advice.

A. Section 162(a) – Trade or Business Nexus

To be deductible under section 162(a), an expense must be directly connected with, or pertain to, the taxpayer's trade or business. Treas. Reg. § 1.162-1(a); see also Kornhauser v. United States, 276 U.S. 145, 153 (1928) (characterizing the required nexus as a "direct" or "proximate" connection).

Two revenue rulings illustrate the nexus requirement for contractual arrangements that are comparable to the Policy. These are Rev. Rul. 55-264 (1955-1 C.B. 11) and Rev. Rul. 58-480 (1958-2 C.B. 62).

In Rev. Rul. 55-264, the Service determined that an insurance premium was deductible where the policy reimbursed the taxpayer for business overhead expenses incurred during prolonged periods of disability due to injury or sickness.

In Rev. Rul. 58-480, the Service ruled that that amounts outside of overhead expenses were not deductible. The ruling reasoned:

> where the terms of an insurance policy provide that the benefit payments to be made are for loss of income, dismemberment, or loss of life, but do not specifically provide that the payments under the contract are to reimburse the policyholder for certain business overhead expenses incurred by him during a period of disability due to injury or sickness, the premiums paid on such a policy

> do not constitute business expenses and are not deductible under section 162 of the Code.

The reasoning of the revenue ruling was based in part on Blaess v. Commissioner, 28 T.C. 710 (1957). In that case, a medical doctor claimed a deduction for premiums paid toward three health and accident insurance policies, each of which would provide payments in the event the doctor became fully or partially disabled and, thus, unable to perform his occupational duties. Id. at 711–12. The Tax Court disallowed the deduction because, although the payments depended on the doctor's inability to perform his occupation, they were unrelated to his business: the doctor was entitled to receive payments under the policies even if he incurred no business related expenses at all (if, for example, he closed his practice). Id. at 714–15. The fact that the doctor intended to use to the payments to pay his office expenses could not, the Tax Court said, be determinative of the question. Id. at 715–16. These authorities establish that, in analogous circumstances, the contingencies contemplated by the parties' arrangement must be directly connected with, or pertain to, the taxpayer's trade or business to allow the deduction of any related premium expense under section 162(a).

Applying the above described test to the facts of this case shows that Taxpayer's premium payments are not deductible under section 162(a). The reimbursable claims under the Policy are unrelated to any purported trade or business activities of Taxpayer (regardless of the trade or business in which it might be engaged). Under the terms, as long as Taxpayer fulfills its obligations under the Policy (e.g., by promptly reporting circumstances that might lead to a claim), it is entitled to payment for amounts calculated with reference to the disallowed conservation easement deduction. This outcome under the Policy occurs whether or not Taxpayer incurs any expenses related to any trade or business, for example, , , or . The contingencies triggering a claim pertain not to business activities or business needs of Taxpayer, but rather subsequent actions of the IRS or other taxing authority. Taxpayer can suspend all business activities on the property without affecting its entitlement under the Policy. Moreover, as any reimbursement under the Policy will pass through to Taxpayer's members—and the Policy, reflecting this, insures Member and its investors—the Policy's terms are necessarily unrelated to any trade or business activities at the partnership level.[3] As a result, similarly to circumstances involving the doctor in Blaess, the premium paid toward the Policy is not deductible under section

[3] The issue of whether the trade-or-business requirement of section 162(a) has been met is determined at the level of the partnership, not the partners. See Brannen v. Commissioner, 78 T.C. 471, 502–05 (1982) (discussing Madison Gas & Electric Co. v. Commissioner, 72 T.C. 521, 564–65 (1979), aff'd 633 F.2d 512 (7th Cir. 1980); Goodwin v. Commissioner, 75 T.C. 424, 434–39 (1980)).

162(a).[4] This conclusion means that it is necessary to determine whether section 212 allows a deduction for the premium payments at issue in this case.

B. Section 212(1)–(2) – Income Production Nexus

Individuals are not limited to section 162 for investment-related deductions. Section 212 was enacted to create parity between nonbusiness expenses and similar business expenses that had long been deductible under the predecessor to section 162(a). See United States v. Gilmore, 372 U.S. 39, 45 (1963); Brown v. United States, 526 F.2d 135, 138 (6th Cir. 1975). As a result, sections 162(a) and 212 are generally considered in pari materia, and the restrictions and qualifications applicable to the deductibility of trade or business expenses are also applicable to income-production expenses covered by section 212(1)–(2). Johnsen v. Commissioner, 794 F.2d 1157, 1162 (6th Cir. 1986); Leigh v. United States, 611 F.Supp. 33, 36 (N.D.Ill. 1985).

Although not requiring engagement in a trade or business as section 162 does, section 212(1)–(2) requires a profit motive. Treas. Reg. § 1.183-2(a). The expectation of a profit need not even be reasonable, but, to be deductible under section 212(1)–(2), an expense must bear a reasonable and proximate relation to the production or collection of income, or to the management, conservation, or maintenance of property held for production of income. Treas. Reg. § 1.212-1(d); see Blaess, 28 T.C. at 716.

The Policy at issue here—and thus its related premium—is unrelated to any income producing activity of Taxpayer.[5] Neither the deduction itself, nor any insurance payout for its disallowance, arises as a result of any purported investment activity, or is correlated to the success or failure of such activity. This is true whether Taxpayer's investment strategy contemplates future sale of the fee or continued leasing of the Property. As a result, the premium paid toward the Policy is not deductible under section 212(1)–(2).

C. Section 212(3) – Expenses Related to Determination, Collection, or Refund of a Tax

Section 212(3) allows the deduction of expenses related to the determination, collection, or refund of any tax. The standards for allowing the deduction under 212(3) are less strict in the sense that they do not have the nexus requirement of section 212(1)–(2). In this vein, expenses under 212(3) are deductible regardless of whether directly or

---

[4] Because the expense must be incurred "in" carrying out the trade or business, the premium at issue here is nondeductible without regard to whether the Policy constitutes insurance for federal income tax purposes. Accordingly, this advice need not address whether the premium at issue here would be deductible if the expense was incurred in carrying out the trade or business and the Policy was determined to be insurance.

[5] Although section 702(a) requires each partner to take into account that partner's distributive share of a section 212 deduction separately, section 702(b) establishes that the characterization of such a deduction is determined at the level of the partnership.

proximately connected to an income producing activity. See Stussy v. Commissioner, T.C. Memo. 2003-232 at *4 (exception in section 212(3) was prescribed specifically by Congress to allow taxpayers to deduct a personal expense that would otherwise be nondeductible and allowing section 212(3) deduction despite absence of income producing activity).

Significantly, however, section 212(3) does not encompass amounts representing federal income tax. See section 275. Although, to date, no court has addressed the deductibility of contracts resembling insurance under section 212(3), courts have denied deductions under the analogous predecessor provisions for other types of contractual arrangements, concluding that the purported expenses were, in fact, merely the contractual relabeling of non-deductible tax. See Edwin J. Schoettle Co. v. Commissioner, 3 T.C. 712, 718 (1944), aff'd 147 F.2d 549, (3d Cir.1945) (bond represented amounts of tax); Globe Products Corp. v. Commissioner, 72 T.C. 609, 618–19 (1979) (sharing agreement among former subsidiaries included amounts of tax).

In addition to these cases, the New York State Bar Association ("NYSBA") in 1984 issued a report on "tax audit insurance" that considered the deductibility of premiums for such insurance in light of section 212(3). N.Y. State Bar Ass'n Tax Section, A Report on Tax Audit Insurance, reprinted in 22 Tax Notes 53 (1984). Like the Tax Court in Blaess, the NYSBA assessed the deductibility of premiums paid for these policies by looking at what exactly the policies were meant to reimburse:

> The Committee believes that under present law a premium paid for tax audit insurance is not deductible to the extent that it is allocable to the cost of providing reimbursement for tax deficiencies, since a taxpayer is not allowed any deduction, exclusion or credit for federal income tax. On the other hand, such a premium is probably deductible to the extent that it is allocable to the cost of providing reimbursement for professional fees, since a deduction is allowed under section 212 of the Code for the costs of contesting a proposed tax deficiency.

Id. at *7.

The NYSBA's logic is sound, and it supports denying the deduction in the instant case. There is no indication that any portion of the premium paid for the Policy is specifically allocated to professional expenses incurred contesting a tax deficiency. In fact, while the Policy requires Taxpayer to secure written consent from the insurer prior to entering any settlement agreement that would result in a loss, the insurer has no obligation under the Policy to defend or pay the defense costs of any proceeding against Taxpayer related to the deduction. Moreover, the costs of such defense are excluded from the Policy's definition of loss. Because the insurer is under no obligation to perform any services related to a tax proceeding, no portion of the premium can be regarded as consideration for such services. Thus, we conclude the contract explicitly contemplates the reimbursement of non-deductible tax and penalty amounts.

In view of the foregoing, the premium paid toward the Policy is not deductible under 212(3).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-3225 if you have any further questions.