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IRS RULING CONFIRMS EXCHANGE OF COLI ON FORMER EMPLOYEES TRIGGERS LOSS OF INTEREST DEDUCTIONS

By John T. Adney and Bryan W. Keene

On March 5, 2011, the Internal Revenue Service (IRS) issued Revenue Ruling 2011-9,[1] which addresses the implications under section 264(f) of a tax-free exchange of corporate-owned life insurance (COLI) contracts.[2] The ruling concludes that such an exchange will result in a loss of the contract's exception to section 264(f)(1) for employee coverage if, at the time of the exchange, the insured is no longer an employee, but rather is a former or "inactive" employee, of the corporate policyholder. This confirms in published guidance an IRS position that has been well-known since the IRS first expressed it in a 2006 private letter ruling.[3]

Section 264(f)(1) imposes restrictions on the deductibility of interest expenses by a business taxpayer that owns or benefits from life insurance contracts, *i.e.*, the typical COLI or bank-owned life insurance (BOLI) contract. Section 264(f)(4)(A) provides an exception to this rule for a contract owned by an entity engaged in a trade or business if the contract covers a single insured who falls within a specified class (a "permitted insured"). A permitted insured is an individual who, at the time first covered by the contract, is a 20-percent owner of the entity or is an officer, director, or employee of the trade or business. Thus, the exception to the normal interest expense limitation rule is sometimes called the "employee coverage exception." The new ruling concludes that, for purposes of this exception, an individual is a permitted insured "at the time first covered" by the contract only if he or she holds that status when the contract is issued, whether in a new purchase or in a subsequent exchange. As a result, the ruling also concludes that if a contract that met the employee coverage exception when it was first purchased is subsequently exchanged for a new contract at a time when the insured is a former employee, the employee coverage exception will be lost for the contract going forward.

The ruling reaches these conclusions in the context of two hypothetical situations involving tax-free exchanges of COLI contracts. In both situations, a corporate taxpayer has substantial indebtedness (unrelated to life insurance purchases) on which it incurs interest expense. The taxpayer purchases a life insurance contract covering the life of an individual who, at the time of purchase, is an employee of the taxpayer. The taxpayer then exchanges the contract for a new one in a section 1035 exchange. The new contract has the same death benefit as the old and covers the life of the same individual. In the first situation, the insured is still the taxpayer's employee at the time of the exchange. In the second situation, the insured is no longer an employee when the exchange occurs.[4]

The ruling states that in both situations the employee coverage exception applies before the exchange, because the insured was the taxpayer's employee when the taxpayer originally purchased the contract. Likewise, the ruling states that in the first situation the exception applies to the new contract issued in the exchange because the insured was still the taxpayer's employee when the new contract was issued. In the second situation, however, the insured was not the taxpayer's employee when the new contract was issued in the exchange, so the ruling concludes that the employee coverage exception does not apply to the new contract in that situation.

In support of this conclusion, the ruling cites to various authorities reflecting the view that a life insurance contract received in exchange for an existing life insurance contract is treated as a new contract issued on the date of the exchange. For example, the ruling observes that such treatment of exchanges generally applies "for purposes of testing [a] contract's qualification as a life insurance contract under [section] 7702."[5] Likewise, the ruling observes that a contract received in an exchange is treated as a new contract for purposes of applying the 7-pay test of section 7702A(b) to determine whether the contract is a modified endowment contract.[6]

The ruling also recognizes that, in some cases, the tax attributes of a life

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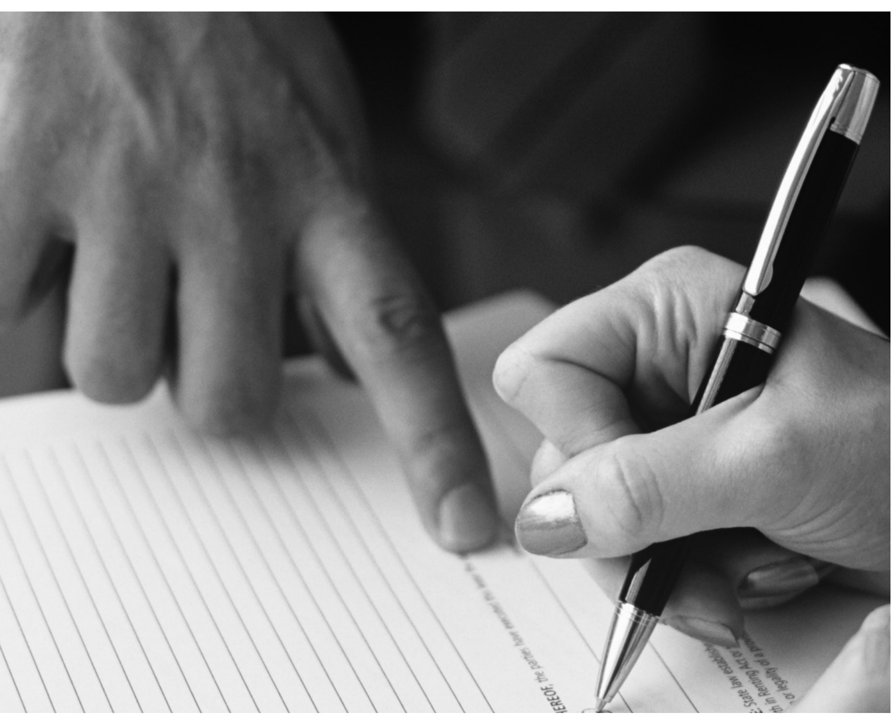
insurance contract may carry over to a new contract received in an exchange. The ruling further states, however, that such carryover treatment is limited to situations where Congress has specifically allowed it. For example, the ruling states that carryover treatment for exchanges is allowed for purposes of the effective date of section 101(j) (the so-called "COLI best practices" rules),[7] as well as for purposes of sections 72(q)(2)(I) and (u)(4) (defining an "immediate annuity").[8] Absent a similar directive by Congress for purposes of section 264(f)(4)(A), the IRS treated the exchange as resulting in a new contract with a new issue date for purposes of that section.

While the ruling addresses only an actual exchange of one contract for another, the same conclusion presumably would apply if a deemed exchange were to arise. In that regard, in some cases a material change in existing property will result in a deemed exchange (and, hence, "new contract" treatment in the case of life insurance) for federal income tax purposes even if no actual exchange of property occurs.[9] In the life insurance context, a "material change" in a life insurance contract generally will result in a deemed exchange.[10] For example, the legislative history of section 7702 discusses the treatment of exchanged contracts as new contracts, and goes on to state that:

> a change in an existing contract will not be considered to result in an exchange, if the terms of the resulting contract (that is, the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges) are the same as the terms of the contract prior to the change.[11]

The potential implication of this language is that a change in an existing contract will be considered to result in an exchange if that change is made to, *inter alia*, the rate or rates of interest guaranteed on issuance of the contract, and that such a deemed exchange will result in the contract being treated as newly issued on the date of the exchange for purposes of section 7702. If the IRS were to extend this view to section 264(f)(4)(A), which it presumably would base on the interpretation it adopted in Rev. Rul. 2011-9 and the lack of any contrary congressional directive, then the "time first covered" requirement of the employee coverage exception would seem to apply anew as of the date of the material change, just as it applies anew in the context of actual exchanges according to the ruling.

As indicated above, the position that the IRS adopts in Revenue Ruling 2011-9 with respect to actual exchanges was first stated in a private letter ruling in 2006.[12] As a result, the interpretation should not come as a surprise to anyone. What the published guidance does, however, is to state the position in a form that applies to all taxpayers, whereas a private letter ruling applies only to the particular taxpayer to which it is issued. Given that the IRS position is now clearly stated in published guidance, any COLI or BOLI policyholders who have taken a contrary position in the past may need to amend their tax returns and adjust their returns going forward, since the new ruling is an interpretation of existing law and the IRS did not limit its effect to prospective tax years or transactions.



END NOTES

1 2011-12 I.R.B. 554.
2 Each reference to a "section" is to a section of the Internal Revenue Code of 1986, as amended (the "Code").
3 PLR 200627021 (July 7, 2006).
4 Although not mentioned in the ruling, the second situation assumes that state insurable interest laws are satisfied with respect to the coverage on the former employee's life following the exchange. The authors' understanding is that this assumption would be true only in certain states, *e.g.*, Georgia.
5 The ruling cites to S. Rep. No. 98-169, at 579 (1984) (the "DEFRA Senate Report"), and section 5.01 of Notice 2006-95, 2006-2 C.B. 848, for this proposition.
6 The ruling cites H.R. Rep. No. 100-1104, at 98 (1988) for this proposition.

END NOTES CONT.

7 Despite this generous grandfathering rule under section 101(j), the IRS has taken a very narrow view in enforcing it by stating in published guidance that any "material change" to a contract involved in a section 1035 exchange (other than changing the issuer) will result in a loss of grandfathering under section 101(j). *See* Q&A-15 of Notice 2009-48, 2009-24 I.R.B. 1085. *See* also John T. Adney and Bryan W. Keene, "Guidance Released on COLI Best Practices," *Taxing Times*, vol. 5, issue 3, at 37 (Sept. 2009).

8 *See* Rev. Rul. 92-95, 1992-2 C.B. 43. For purposes of sections 72(q)(2)(I) and (u)(4), an "immediate annuity" is defined, in relevant part, as a contract under which the annuity starting date is no more than one year from the "date of the purchase of the annuity." Rev. Rul. 92-95 states that for this purpose the "date of purchase" of a contract received in a section 1035 exchange is the same "date of purchase" as the contract being exchanged. This interpretation was necessary to enforce the intent of the relevant Code sections; otherwise, a deferred annuity with considerable tax-deferred inside buildup could be exchanged for a payout annuity and qualify as an immediate annuity. The ruling cites the legislative history of section 72(q) in support of this interpretation.

9 The Supreme Court has viewed properties as "different" in a sense that is "material" to the Code if the properties' respective legal entitlements were different in kind or extent. Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 565 (1991).

10 *See, e.g.*, TAM 9347005 (Aug. 10, 1993) (concluding that a section 1035 exchange occurred where policyholders accepted an offer by a life insurance company to issue an endorsement that would permanently increase the minimum interest rate guaranteed under the contract, thus effecting a material change in the terms of the contract).

11 DEFRA Senate Report, *supra* note 5. *See also* H.R. Conf. Rep. No. 98-861, at 1076 (1984) (stating that the conference report follows the DEFRA Senate Report); Staff of the J. Comm. on Tax=n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 656 (J. Comm. Print 1984) (same language as DEFRA Senate Report).

12 PLR 200627021 (July 7, 2006).