DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, LMSB, AREA 3

FROM: Mark S. Smith

SUBJECT: Questions under section 264 - Part 2 of 2

This Chief Counsel Advice responds to your memorandum dated August 15, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

<u>LEGEND</u>
Taxpayer

Amount 1
Amount 2
Amount 3
Number 4
Amount 5a
Amount 5b
Amount 6a
Amount 6b
Amount 7a
Amount 7b
Amount 8a
Amount 8b
Amount 9
Insurer
Date A
Year B
Date C
Date D
Date E
Date F

ISSUE

Under the facts presented, what is the proper application of the 4 out of 7 exception of § 264(d)(1) of the Internal Revenue Code?

CONCLUSION

By reason of the transition rules in the 1996 amendments to § 264, we do not believe you can argue that the taxpayer failed the 4 out of 7 exception where no premiums were paid – from borrowing – after the end of the third policy year.

FACTS

Prior to Year B, Taxpayer purchased corporate-owned life insurance contracts (the Contracts) on the lives of certain of its employees. Taxpayer typically borrowed against the policies to fund premium payments as due. In Year B, Taxpayer replaced these policies with new life insurance contracts (collectively referred to as the Plan) issued by Insurer. The issue of whether the transaction replacing old Contracts with new Contracts constituted a new purchase for purposes of then § 264(a)(4) is being addressed in a separate FSA concerning this Taxpayer. For this memorandum, we assume that the limitations of that subsection apply.

Both the old and the new Contracts provided an Amount 1 death benefit to each covered employee. The premiums for the Amount 1 death benefit were paid by Taxpayer. Employees could buy additional insurance through payroll withholding. The employees were named as beneficiaries under the policies so long as the employee worked for Taxpayer. If the employee stopped working for Taxpayer, the Contract insuring that employee could be distributed to the employee, if the employee wished, and the former employee would pay all future premiums. If the employee chooses not to separate his or her individual contract from the Plan upon cessation of employment, Taxpayer could elect to continue coverage and change the beneficiary to itself or whomever Taxpayer wished to designate. In addition, Taxpayer was allowed to increase the death benefit above Amount 1 at any time prior to termination of employment, for which benefit Taxpayer would pay additional premiums and be named beneficiary.

The Insurer and Taxpayer executed a Binder Agreement dated Date C that proposed issuance of the new Contracts under the Plan, secured by a payment of Amount 2 (Amount 3 times Number 4 employees), Insurer agreed to issue the Plan Contracts effective Date D (approximately 10 days earlier than the date of the Binder Agreement), provided two conditions were satisfied:

(A) Taxpayer paid the entire first year premium of Amount 5a on or before Date E, and
(B) Taxpayer provided Insurer the written consent of all covered employees, also prior to Date E.

After Date C and one month prior to Date E, Taxpayer borrowed Amount 9 from other COLI policies not included in the Plan. Short-term borrowing was a usual part of Taxpayer's business and its short-term debt as of the end of the prior month was approximately 3-1/2 times Amount 9. In the month in which Amount 9 was borrowed, Taxpayer had obligations for stock repurchases and acquisition costs that also required cash. The amount borrowed from the other COLI policies was approximately 104% of the Amount 5a first year premium.

Two days prior to Date E, Taxpayer paid Insurer Amount 5a, the remainder of the premiums due for the Plan policies for the first policy year beginning Date E. One day later, Taxpayer borrowed Amount 5b against the cash surrender value of the Plan policies, an amount less than the annual premium of Amount 5a and also less than the cash surrender value of the Contracts. The amount of cash out of pocket that Taxpayer paid as of Date E was approximately 12 percent of Amount 9.

Similarly, for the second policy year of the Plan, Taxpayer paid the aggregate premium due of Amount 6a, two days after the beginning of the policy year. Taxpayer immediately borrowed Amount 6b, an amount less than 6a, also secured by the cash surrender value of the Plan policies.

The third year's premiums due of Amount 7a were paid by wire transfer the day before the beginning of the policy year. Taxpayer immediately borrowed Amount 7b, which exceeded Amount 7a. However, Amount 8b (the total amount borrowed against the Contracts during the first three policy years) did not exceed Amount 8a (the three annual premiums due and paid during the first three policy years), much less the accumulated cash surrender value in the Contracts.

Taxpayer chose not to pay any further premiums due on the Plan policies beginning with the fourth policy year. That date was after October 13, 1995. As a result, at of the beginning of the fourth policy year, the policies lapsed to extended term insurance per the nonforfeiture provisions of each policy.

<u>LAW AND ANALYSIS</u>

Section 264 limits the ability of the owner of a life insurance contract to deduct otherwise deductible interest on policy loans secured by the cash value of the contract. When the Plan policies were first issued, then § 264(a)(4) disallowed the deduction of interest on loans to the extent that the loans exceeded $50,000 cumulatively. The $50,000 loan limit was a practical cap on borrowing on any one contract. Planning around this statutory limit produced corporate owned life insurance (COLI) programs where very large numbers of employees were insured in order to maximize the available deductions. Several such programs have been and still are being successfully litigated by the Service as being economic shams.[1]

However, even for a valid transaction, the interest on a loan of $50,000 or less might not be deductible under the rules applicable before 1996. Subject to the exception contained in then § 264(c), interest was not deductible if

> incurred or continued to purchase or carry a life insurance ... contract ... pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise).

Section 264(a)(3) (the general rule). However, a policyholder could borrow systematically using the cash value of the policy as security if the plan satisfied the requirements of the exception set forth in (then) § 264(c)(1) which allowed the deduction of otherwise non-deductible interest

> if no part of 4 of the annual premiums due within the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness....

This is the so-called “4 out of 7" exception.

One permissible pattern for complying with the 4 out of 7 exception is for the policyholder to borrow the maximum permissible amount during the first three years and then to pay the premiums due during the next four years.[2] Under the facts submitted, the aggregate loans of Amount 8b do not exceed the annual premiums due for the first three policy years. Each of the Contracts within the Plan lapsed to extended term status due to nonpayment of premiums before the payment of the four premiums contemplated by the 4 out of 7 exception began. This failure to complete the full seven years with its mandatory payment of four premiums is not, however, dispositive of whether Taxpayer satisfied § 264(c)(1) and thus § 264(a)(3) because the law changed in the middle of that seven year period.

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[1] See American Electric Power v. United States, (Slip Opinion, USDC SD Ohio, 2001) (6th Circuit appeal pending); CM Holdings v. United States, 254 B.R. 578 (USDC D. Del. 2000), (3rd Circuit appeal pending); Winn-Dixie Stores v. Commissioner, 113 T.C. 254 (1999) (affirmed per curiam 11th Circuit).

[2] The issue of whether payment of the unborrowed premiums may be through application of loading dividends, partial withdrawals, or other mechanisms is complex and is currently being litigated. See the cases cited in footnote 1 and the Appeals Settlement Guidelines on this issue.

In 1996, the rules governing the deductibility of interest on indebtedness secured by COLI contracts was substantially modified, severely restricting and, in most cases, eliminating the ability to deduct such interest. In recognition of the likelihood that many COLI programs would no longer have economic viability due to the loss of the associated tax benefits, transition rules were included in the legislation that allowed owners to exit the programs. Specifically, section 501(d)(2) of the Health Insurance Portability and Accountability Act of 1996 (the 1996 Act), 1996-43 I.R.B. 7, provided that a contract was not to be treated as failing the 4 out of 7 exception of prior § 264(c)(1)

> solely by reason of a lapse occurring after October 13, 1995, by reason of no additional premiums being received under the contract.

Accordingly, provided that the relationship of indebtedness to the premiums paid under a contract met the 4 out of 7 exception up to the date of the lapse, the lapse itself would not cause failure to meet the exception. That appears to be the case here.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

You should note that the years at issue predate the enactment of section 264(f), which now provides explicit authority to allocate a portion of a taxpayer's interest expense to policy cash surrender values. [redacted]

You also ask, implicitly, whether our conclusion is in any way affected by the borrowing of Amount 9 against other COLI policies before Date E. According to your submission, Taxpayer's total short term borrowing during this time frame was roughly 3-1/2 times the amount of the first year's premium under the Contracts, and, during this time frame, Taxpayer also used funds to repurchase stock and for acquisitions. [redacted]

[redacted]

[redacted]

You also should note that our conclusion that this Taxpayer satisfied the 4 out of 7 exception does not mean the interest at issue in this case is necessarily deductible. Only otherwise allowable interest on bona fide debt is deductible. This requires examination of the debt transaction under the rules of § 163 and general tax principles explained in detail in the cases cited in footnote 1. See also, H.R. (Conf.) Rpt. 104-736, 104th Cong., 2d Sess. 319-322 (1996) (discussing the rules applicable to COLI interest deductions). Only if the interest is otherwise be deductible under the remainder of the Code do you begin to analyze whether to apply the disallowance rule and exception contained in § 264. Specifically, the interest is not deductible if it arises from an economic sham in substance intended only to produce tax benefits.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Sincerely,
MARK S. SMITH
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)