

Legal Updates & News

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Third-Party Purchaser's E&P Reduced by Interest on Loan Incurred to Acquire Life Insurance Policy

September 2009

by [Robert A. N. Cudd](#), [Michelle Jewett](#)

Revenue Ruling 2009-25 (the "Ruling"), 2009-38 I.R.B., addresses the issue of when interest that is disallowed as a deduction under Section 264(a)(4) of the Internal Revenue Code (the "Code") is taken into account in determining earnings and profits ("E&P") of a third-party purchaser (the "Purchaser") of a life insurance contract. The Ruling concludes that interest, even though disallowed under Code Section 264(a)(4), reduces the Purchaser's E&P for the tax year in which the interest would have been allowable as a deduction. However, the Ruling also determines that when the death benefit is received under a life insurance contract, E&P cannot be further reduced.

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The Ruling is likely to be most relevant to a U.S. shareholder of a controlled foreign corporation ("CFC") that has "subpart F" income. Although E&P is used to determine whether a corporation's distributions to shareholders are treated as "dividend" income for U.S. federal income tax purposes, the same concept is also relevant to the U.S. shareholders of a CFC, who must annually include their pro rata shares of the corporation's subpart F income in their U.S. tax returns up to the amount of the CFC's E&P. In confirming that the E&P of a CFC is reduced currently by items of disallowed interest expense, the IRS took a position that is consistent with the view of E&P as a reflection of the CFC's ability to pay dividends.

Facts

On the first day of Year 1, the Purchaser, a subchapter C corporation, purchased a paid-up life insurance contract from an unrelated individual (the "Insured") for \$100. The Purchaser financed the purchase of the life insurance contract by borrowing \$100 at 7 percent simple interest per annum. In Year 1 and Year 2, the Purchaser paid \$7 of interest, which would have been deductible but for the interest disallowance provision in Code Section 264(a)(4), which generally disallows a deduction for interest on indebtedness for life insurance policies owned by a taxpayer covering the life of an individual. On day 1 of Year 3, the life insurance contract matured and the Purchaser received the \$500 death benefit. In accordance with Code Section 101(a)(2), the Purchaser included \$386 in its gross income (\$500 (death benefit) – \$100 (amount paid for the contract) – \$14 (disallowed interest deductions in Year 1 and Year 2)).

IRS Analysis

IRS concluded that, because interest disallowed under Code section 264(a)(4) depletes the assets of a corporation at the time such interest would otherwise be allowed, E&P should also be reduced in that year. In both Year 1 and Year 2, the Purchaser should reduce its E&P by the \$7 of Disallowed Interest.

The IRS also determined that reducing E&P in the year the Purchaser received the death benefit by the amount of disallowed interest taken into account under Code section 101(a)(2) would cause an unwarranted double reduction of E&P and, therefore, is not allowed. Thus, although it in Year 3 included in its gross income only \$386 of the \$500, the Purchaser was required to include \$400 (\$500 death benefit – \$100 amount it paid for the contract) in its E&P in Year 3.

Commentary

The Ruling, although not surprising to tax practitioners in its disallowance of “double counting” the E&P reduction, will be beneficial for U.S. shareholders of CFCs that are active in the life settlement market and that have E&P because it allows for immediate reduction of Subpart F income to the extent of interest payments made on the policy acquisition indebtedness. For example, premium financing transactions in which annuities are used to fund annual insurance premiums, will benefit from interest deductions which will reduce the annuity income includible in E&P. However, the Ruling may be unfavorable for U.S. shareholders of CFCs which do not generate current income and have no current E&P because the ruling does not allow interest payments made in prior years to be taken into account when determining the amount of gain on the death benefit for E&P purposes. Accordingly, although the Ruling provides clarity in terms of when to account for disallowed interest in determining E&P, whether or not the conclusion is beneficial will depend on the particular circumstances of the corporation making the interest payments.