



WASHINGTON REPORT

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Subject: **IRS Issues Safe Harbor for Insurance Company-Owned Life Insurance**

Major References: [Revenue Procedure 2007-61](#)

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The Internal Revenue Service is expected to release this week a significant new private ruling (PLR ____, May 3, 2007) concluding that, as a result of 1997 tax law changes, insurers owning life insurance on the lives of their employees are subject to a reduction in income tax deductions for reserves (for life companies) or loss deductions (for non-life companies). Fortunately, the release of the PLR is preceded by the release today of Revenue Procedure 2007-61, in which the Service indicated that it would not apply the holding of the PLR and require insurance companies to reduce their deductions if the insurance arrangement meets an easily-satisfied safe harbor test set forth in the Revenue Procedure.

Background on 1997 Tax Law Changes

In 1997, Congress became aware that Fannie Mae was proposing to purchase life insurance policies on the lives of thousands of borrowers whose mortgages it held. This proposed insurance arrangement was unusual and departed significantly from more traditional uses of life insurance such as corporate-owned life insurance ("COLI") policies on the lives of a company's owners, officers, directors, and employees. In order to address the arbitrage inherent in Fannie Mae indirectly using borrowings for which interest was deductible to fund premiums for non-taxable life insurance benefits, Congress enacted the pro rata interest disallowance rules of section 264(f).

Under section 264(f), a business taxpayer's interest expense is disallowed in proportion to the unborrowed policy cash values on life insurance policies (issued after June 8, 1997) owned by the taxpayer. Consistent with the Congressional purpose of addressing the Fannie Mae arrangement while

leaving undisturbed traditional COLI arrangements, section 264(f)(4) provides that the pro rata interest disallowance rules of section 264(f) do not apply to policies on the lives of individuals who, when first covered, were 20-percent owners, officers, directors, or employees of the business. This officer, employee, etc. provision, while drafted as an “exception,” is, practically speaking, the general rule in terms of the number of situations to which it applies.

As part of the provision enacting section 264(f), Congress chose an alternative manner of implementing the provision for insurance companies. Accordingly, section 264(f)(8) makes section 264(f) inapplicable to any insurance company. Instead, the rules relating to reserve deductions for life insurance companies and loss deductions for non-life companies were modified to reduce those deductions by a portion of the cash value build-up “of life insurance policies and annuity and endowment contracts to which section 264(f) applies.” See, sections 807(a)(2)(B), 807(b)(1)(B), 832(b)(5)(B)(iii). The modified rules reduce life insurance company deductions for reserves by the "policyholders' share" of the increase in applicable policy cash values. For other insurance companies, loss deductions are reduced by 15% of the life insurance policy cash value build-up for the year for applicable policies.

Private Ruling

The new private ruling considered the question of whether the reference, in the reserve and loss deduction rules, to policies "to which section 264(f) applies" also incorporates the officer, employee, etc. exception available under section 264(f)(4). The ruling concludes that the reference to "264(f)" in the reserve and loss deduction rules covers all post-June 8, 1997, policies, and does not include an exception for policies on owners, officers, directors, or employees.

Knowledgeable practitioners believe the PLR is incorrect for numerous reasons including that it misreads the applicable statutes (and the relevant effective dates), ignores the legislative background of the 1997 changes, ignores “common-sense” interpretation, and relies on 1984 legislative history that is irrelevant to the question at hand. While a private ruling has no precedential value, the PLR, if it signaled the position of the Service, would nonetheless raise significant concerns for insurers that may have purchased COLI on the lives of their officers and employees after June 8, 1997. However, these concerns are addressed, for all practical purposes, by the issuance of Rev. Proc. 2007-61.

Revenue Procedure 2007-61 Safe Harbor

In recognition of the fact that the PLR’s conclusion came as an unpleasant surprise to the insurance industry and was likely to be challenged in court if applied in the context of an audit, the Service in conjunction with the release of the PLR put out Revenue Procedure 2007-61. In the Revenue Procedure, the Service announced that it would not apply the conclusion of the PLR to insurer COLI arrangements in which the arrangements cover no more than 35 percent of the total aggregate number of individuals described in section 264(f)(4)(A) at any time during the taxable year. For arrangements covered by the safe harbor, an insurance company is not required to take into account, for purposes of sections 807(a)(2), 807(b)(1), 805(a)(4), 812, or 832(b)(5), any portion of the increase for the taxable year in the policy cash values.

The safe harbor provided in Revenue Procedure 2007-61 is effective September 11, 2007. If, in response to comments, the IRS publishes additional guidance interpreting the phrase “contracts to which section 264(f) applies,” such guidance will apply prospectively.

Because the safe harbor, as a practical matter, covers the facts in the typical insurer-owned COLI arrangement following industry best practices and, since last year, section 101(j), it renders the PLR largely irrelevant.

In response to the Service's request contained in Rev. Proc. 2007-61, AALU intends to submit a comment applauding the safe harbor but indicating disagreement with the conclusion in the PLR.

Any AALU member who wishes to obtain a copy of Rev. Proc. 2007-61 may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Erik Ruselowski at ruselowski@aalu.org and include a reference to this *Washington Report*.

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