Internal Revenue Service

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Washington, DC 20224

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Person To Contact:
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Telephone Number:

Refer Reply To:
CC:FIP:B04
PLR-163267-05
Date:
April 06, 2006

In Re:

Taxpayer =

Date x =

Date y =

Individual A =

Bank Z =

Dear :

This is in response to the December 16, 2005 letter submitted by Taxpayer requesting a ruling concerning the application of section 264(f) of the Internal Revenue Code to a life insurance contract of which Taxpayer is the owner and beneficiary.

FACTS

Taxpayer is engaged in the business of providing consulting services to U.S. organizations. The Taxpayer files a consolidated federal income tax return with its wholly owned subsidiaries on a calendar year basis using the accrual method of accounting.

On date x, Taxpayer purchased a life insurance contract ("Contract") insuring the life of individual A ("Insured"). Contract is held by bank Z for the benefit of Taxpayer under a trust arrangement. For purposes of this ruling request, Taxpayer represents that the trust arrangement is that of a grantor trust, with Taxpayer treated as the owner of the trust's assets for tax purposes. Taxpayer is the sole beneficiary of Contract.

Taxpayer intends to exchange Contract for a life insurance contract (“New Contract”) issued by a life insurance company that is different than the life insurance company that issued Contract. On the date of the exchange, New Contract will also insure the life of Insured and will have the same death benefit as Contract.

On the date Contract was issued, Insured was an employee of Taxpayer. Insured terminated employment with Taxpayer on date y and will not be an employee of Taxpayer on the date Contract is exchanged for New Contract.

Taxpayer has substantial general indebtedness on which it incurs interest expense.

Taxpayer represents that both Contract and New Contract are life insurance contracts as defined in section 7702.

LAW

Section 264(f)(1) states that no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to unborrowed policy cash values.

Under section 264(f)(2), the portion of the taxpayer's interest expense which is allocable to unborrowed policy cash values is an amount which bears the same ratio to such interest expense as the taxpayer's average unborrowed policy cash values of life insurance policies, and annuity and endowment contracts, issued after June 8, 1997, bears to the sum of (i) in the case of assets of the taxpayer which are life insurance policies or annuity or endowment contracts, the average unborrowed policy cash values of such policies and contracts, and (ii) in the case of assets of the taxpayer not described in (i), the average adjusted bases (within the meaning of section 1016) of such assets.

Under section 264(f)(3), the term "unborrowed policy cash value" means, with respect to any life insurance policy or annuity or endowment contract, the excess of (A) the cash surrender value of such policy or contract determined without regard to any surrender charge, over (B) the amount of any loan with respect to such policy or contract. If the amount described in (A) with respect to any policy or contract does not reasonably approximate its actual value, the amount taken into account under (A) shall be the greater of the amount of the insurance company liability or the insurance company reserve with respect to such policy or contract (as determined for purposes of the annual statement approved by the National Association of Insurance Commissioners) or shall be such other amount as is determined by the Secretary.

Section 264(f)(4) states that section 264(f)(1) shall not apply to any policy or contract owned by an entity engaged in a trade or business if such policy or contract covers only one individual and if such individual is (at the time first covered by the policy or contract) (i) a 20-percent owner of such entity, or (ii) an individual (not described in (i)) who is an officer, director, or employee of such trade or business.

Section 264(f)(7) states that the term "interest expense" means the aggregate amount allowable to the taxpayer as a deduction for interest (within the meaning of section 265(b)(4)) for the taxable year (determined without regard to this subsection, section 265(b), and section 291).

Section 264(f) was enacted by the Taxpayer Relief Act of 1997, Pub. L. No. 105-34. Section 1084 of Pub. L. No. 105-34 (as amended by section 6010 of Pub. L. No. 105-206) states that section 264(f) shall apply to contracts issued after June 8, 1997, in taxable years ending after such date, and that any material increase in the death benefit or other material change in the contract shall be treated as a new contract.

ANALYSIS

The section 264(f) deduction disallowance of that portion of Taxpayer's interest expense that is allocable to unborrowed policy cash values did not apply to Contract because Insured was, at the time first covered by Contract, an employee of Taxpayer. However, subsequent to the date Contract was issued, Insured terminated employment with Taxpayer and will not be an employee of Taxpayer on the date Contract is exchanged for New Contract. For purposes of section 264(f), New Contract will be treated as a different contract than Contract because, at the time of exchange for New Contract, there will be a material change in Contract, e.g., New Contract will be issued by a insurance company different than the insurance company that issued Contract and will have as its insured an individual that is no longer an employee of the owner and beneficiary of the insurance contract. Because New Contract is a different life insurance contract than Contract, and because Insured was not, at the time first covered by New Contract, an employee of the owner of New Contract, the section 264(f) deduction disallowance of that portion of Taxpayer's interest expense that is allocable to unborrowed policy cash values applies to New Contract.

HOLDING

Based on the facts and representations made by Taxpayer, we hold that the section 264(f) deduction disallowance of that portion of Taxpayer's interest expense that is allocable to unborrowed policy cash values applies to New Contract.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect or item discussed or referenced in this letter. The rulings contained in this letter are based upon information and representations submitted by Taxpayer. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination. The ruling is directed only to the taxpayer requesting it. Section 6110(k) provides that it may not be used or cited as precedent. Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

/S/

DONALD J. DREES, JR.
Senior Technician Reviewer
Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)