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If you would like to discuss how the Ruling could apply to your company or if you have other questions about COLI, split dollar or other insurance-based plans, please call one of the following, or the Groom attorney you regularly contact:

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Restrictive New IRS Ruling Affects Tax-Free Exchanges of COLI – A Trap for Unwary Employers?

Many companies have substantial amounts of corporate-owned life insurance ("COLI") on their books. Typically, the policies were purchased to fund future liabilities for deferred compensation, retiree health or other significant corporate liabilities. When the policies do not perform as expected, companies may shop around for better ones. In this regard, section 1035 of the Internal Revenue Code ("Code") allows tax-free exchanges of life insurance as long as the policy is on the same insured and the coverage is generally the same. On March 3, the Internal Revenue Service issued Rev. Rul. 2011-9 ("Ruling," copy attached) to explain how Code section 264(f) nevertheless may result in adverse tax consequences from such a transaction.

Section 264(f) was enacted in 1997 in response to Fannie Mae's purchase of a huge block of policies on third-party insureds. The provision generally disallows a portion of a taxpayer's interest deduction based on the ratio of the sum of the unborrowed cash values on life and annuity contracts it owns to the adjusted basis of all of the taxpayer's assets. Thus, if the total policy cash values equal 5% of the total adjusted basis of assets, the company loses a deduction for 5% of its total interest expense. Significantly, Section 264(f)(4) provides an exception where the insured is an officer, director, employee or 20% owner at the time of policy issuance.

The Ruling holds that the insured employee, director, etc., must still be employed by the company at the time of the tax-free exchange – otherwise, section 264(f) will apply to disallow a portion of the company's deduction for interest on its indebtedness. The Ruling thus makes a 2006 private letter ruling (PLR 200627021) the official IRS position on the issue. The IRS reasons that the absence of a provision in section 264(f) that treats a section 1035 exchange as a continuation of the original policy means that the replacement policy is a new one for purposes of that section.

While the technical basis of the Ruling is reasonably apparent, it ignores important policy considerations. Code section 264(f) recognizes that companies often have a legitimate interest in acquiring policies on their employees and directors. (Indeed, the COLI rule (sec. 101(j)) enacted in 2006 continues to allow tax-free treatment for COLI covering highly compensated employees and directors if certain notice and consent rules are satisfied.) The fact that an employee or director no longer provides services should give way to the basic purpose of section 1035, i.e., to allow a taxpayer to acquire a better policy. Inasmuch as substantial blocks of COLI are likely to cover former employees and directors, the Ruling has the effect of locking in potentially under-performing assets.

We note that the Ruling applies to prior as well as future transactions. Thus, companies should check their COLI holdings to determine if they have already engaged in section 1035 exchanges that could be adversely affected by section 264(f). The Service's hard line on COLI is not surprising – indeed, one of the Administration's tax proposals would expand section 264(f) to generally apply to all of a company's COLI, including policies on current employees and directors.