



## Employer-Owned Life Insurance – IRS Rules on 1035 Exchanges and Code Section 264(F)

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The Internal Revenue Service (IRS) today issued Revenue Ruling 2011-9, addressing “section 1035” exchanges of life insurance policies and the application of section 264(f) of the Internal Revenue Code (Code). Issuance of such guidance had been listed on the IRS/Treasury Department Priority Guidance Plan for some time and had been anticipated. The holding of Revenue Ruling 2011-9, while not unexpected, does constrain the ability of an employer to undertake a section 1035 exchange of life insurance policies that it holds on the lives of employees for new policies.

### Background

Employers commonly purchase life insurance on the lives of employees, officers and directors, and use the death benefits for a variety of corporate purposes, such as the funding of benefits. Deductions for interest expense on borrowings directly related to the purchase or carrying of such policies has long been subject to disallowance under Code sections 264(a)(2) – (4). Since 1997, deductions for interest expense on *unrelated* borrowings also have been subject to disallowance under Code section 264(f). However, disallowance under section 264(f) does not apply if the insured individual is, *at the time first covered by the policy*: (i) a 20-percent owner of the employer; or (ii) an officer, director, or employee (for simplicity, we refer to all of these as “employees”).

### Section 1035 Exchanges

An employer for any number of reasons may desire to exchange an existing policy on an employee for a new, different policy, either from the same insurer (an internal exchange) or a different insurer (an external exchange). Both internal and external exchanges are generally tax-free under Code section 1035. One issue that has arisen is how Code section 264(f) applies to a new policy received by an employer in a section 1035 exchange. Specifically, how does the requirement in section 264(f) that the insured be an employee at the time first covered by the policy apply? Revenue Ruling 2011-9 answers this question.

### Revenue Ruling 2011-9

Revenue Ruling 2011-9 addresses two fact situations. In the first situation, an employer purchases life insurance on an employee who is actively employed by the employer at the time he is first covered under the policy. Subsequently, the employer exchanges this “old” policy for a “new” policy in a section 1035 exchange. At the time the new policy is issued, the employee-insured is still actively employed by the employer.



In the second situation, the facts are the same except that the insured no longer works for the employer at the time the new policy is acquired in the section 1035 exchange.

Revenue Ruling 2011-9 treats the new policy received in a section 1035 exchange as a newly issued policy for purposes of applying section 264(f), regardless of whether it is an internal or external exchange. Thus, in order for the employee exception described above to apply to this policy, the insured under the new policy must be an employee at the time the new policy is received in the 1035 exchange. This means that in the second fact situation, the new policy received in the section 1035 exchange does not qualify for the employee exception to section 264(f), since the insured no longer works for the employer. Accordingly, the employer is subject to a disallowance of a deduction for a portion of its interest expense incurred on unrelated borrowings. Conversely, in first situation, the insured is still actively employed by the employer at the time the new policy is received in the section 1035 exchange, and thus no interest disallowance is triggered under section 264(f) with respect to this new policy.

### Observations

The holding of Revenue Ruling 2011-9 was not unexpected. It is consistent with the treatment of section 1035 exchanges in other contexts and the IRS had previously signaled informally that this was its view.

The practical effect of Revenue Ruling 2011-9 is to deter employers from undertaking section 1035 exchanges of life insurance policies covering the lives of persons who are no longer actively employed.

It should be noted that the Administration's recent budget proposals would repeal the employee exception in Revenue Ruling 2011-9 that is the subject of Revenue Ruling 2011-9. In that event, Revenue Ruling 2011-9 would become moot.

For more information on the matters discussed in *Locke Lord's QuickStudy*, please contact the author:

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