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S corporation; life insurance contract; accumulated adjustments account (AAA). This ruling, under section 1368 of the Code, outlines the effects of premiums paid by an S corporation on an employer-owned life insurance contract and the benefits received by reason of death of the insured on its AAA.

ISSUES

(1) Do premiums paid by an S corporation on an employer-owned life insurance contract, of which the S corporation is directly or indirectly a beneficiary, reduce the S corporation's accumulated adjustments account (AAA)?

(2) Do the benefits received by reason of the death of the insured from an employer-owned life insurance contract that meets an exception under § 101(j)(2) increase an S corporation's AAA?

FACTS

X is a corporation that has a valid S election in effect. X purchases an employer-owned life insurance contract on the life of one of its employees in order to cover expenses the company would incur as a result of the death of the employee (also known as a key-man policy). The employee is a highly compensated employee of X. X pays all of the premiums for the policy. X is a beneficiary of the policy. At the end of the taxable year, X has subchapter C accumulated earnings and profits (E&P).

LAW AND ANALYSIS

Section 101(a)(1) provides that gross income does not include amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured.

Section 101(j)(1) provides that death benefits from employer-owned life insurance contracts shall be taxable, in excess of premiums and other amounts paid, unless the employer-owned life insurance contract meets one of the exceptions provided under § 101(j)(2).

Section 101(j)(2)(A) provides that § 101(j)(1) shall not apply to any amount received by reason of the death of an insured who, with respect to an applicable policyholder (i) was an employee at any time during the 12-month period before the insured's death, or (ii) is, at the time the contract is issued a director, a highly compensated employee within the meaning of § 414(q) (without regard to paragraph (1)(B)(ii) thereof), or a highly compensated individual within the meaning of § 105(h)(5), except that “35 percent” shall be substituted for “25 percent” in subparagraph (C) thereof.

Section 264(a)(1) provides that no deduction is allowed for premiums paid on any life insurance policy, or endowment or annuity contract, if the taxpayer is directly or indirectly a beneficiary under the policy or contract.

Section 1.264-1(a) provides that the premiums paid for life insurance on the life of any officer, employee, or person financially interested in a business carried on by the taxpayer are not deductible where the taxpayer is directly or indirectly a beneficiary of the policy.

Section 1.1366-1(a)(2)(viii) provides that for the purposes of subchapter S, tax-exempt income is income that is permanently excludible from gross income in all circumstances in which the applicable provision of the Code applies and provides as an example that income that is excludible from gross income under § 101 (certain death benefits) is tax-exempt income.

Section 1368(e)(1)(A) provides that the term “accumulated adjustments account” means an account of the S corporation which is adjusted for the S period in a manner similar to the adjustments under § 1367 (except that no adjustment shall be made for income (and related expenses) which is exempt from tax under Title 26 and the phrase “(but not below zero)” shall be disregarded in § 1367(a)(2)).

Section 1.1368-2 provides for the calculation and maintenance of the AAA. The AAA is an account of the S corporation and is not apportioned among shareholders. The AAA is generally increased by the items of income described in § 1366(a)(1)(A), other than income that is exempt from tax, and any nonseparately computed income determined under § 1366(a)(1)(B). The AAA is generally decreased by the items of loss or deduction described in § 1366(a)(1)(A), any nonseparately computed loss determined under § 1366(a)(1)(B), and any nondeductible expense not properly chargeable to a capital account other than expenses related to tax-exempt income.

An S corporation’s AAA tracks the amount of undistributed income that has been taxed to the shareholders, similar to the manner in which E&P generally tracks a C corporation’s undistributed income. The AAA is the mechanism that allows previously taxed but undistributed income to be distributed tax-free to S corporation shareholders to the extent of the shareholders’ basis in their stock.

HOLDINGS

(1) Premiums paid by an S corporation on an employer-owned life insurance contract, of which the S corporation is directly or indirectly a beneficiary, do not reduce the S corporation’s AAA.

(2) The benefits received by reason of the death of the insured from an employer-owned life insurance contract that meets an exception under § 101(j)(2) do not increase the S corporation’s AAA.

DRAFTING INFORMATION

The principal author of this revenue ruling is Vishal R. Amin of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this revenue ruling, contact Vishal R. Amin at (202) 622-3060 (not a toll-free call).