

Internal Revenue Service

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PLR-165118-04

Date:

April 7, 2005

Legend:

Corporation =
Company 1 =
Company 2 =
Company 3 =
Decedent =
State 1 =
State 2 =
State 3 =
State 4 =
State 5 =
Year 1 =
Year 2 =
Year 3 =
A =
B =
C =
D =
E =
Date 1 =

Dear

This letter replies to your letter dated December 10, 2004, as well as other correspondence from your representative, requesting certain rulings with respect to the transaction described below.

FACTS

Corporation is a State 1 corporation with its principal place of business in State 2 and is licensed to conduct business operations throughout the United States including State 3. Company 1 is a life insurance company with its principal place of business in State 4, and Company 2 is a life insurance company with its principal place of business in State 1. Both Company's 1 and 2 are licensed to do business in State 3.

Beginning in Year 1, Corporation purchased, from Company's 1 and 2, corporate owned life insurance (COLI) policies on A of its employees, with Corporation named as beneficiary of the policies. Also, in Year 1, Corporation established a trust to serve as the legal holder of the COLI policies. Company 3 was named as trustee of the trust, and State 5 law was designated in the trust instrument as the law governing the construction, validity, and administration of the trust. Corporation borrowed money from the insurers, based on the cash values of the policies, and used the borrowed funds to pay premiums due on the policies. Corporation claimed tax deductions for the interest paid on the borrowed funds. Upon the death of a covered employee, the insurer paid Corporation the death benefit which Corporation then used to repay the premium loans. After Congress eliminated favorable tax treatment for owners of COLI policies, Corporation unwound its program and surrendered the last of its policies by Year 2.

Corporation's policies insured the lives of all employees who were eligible for enrollment in Corporation's health and welfare plan, unless the employee elected not to participate in a special death benefit program that Corporation introduced in conjunction with the COLI program. Corporation's employees never knowingly consented to Corporation's purchase of insurance on their lives nor designated Corporation as the beneficiary. Neither Corporation nor the insurers informed any of Corporation's employees that Corporation had insured their lives. Approximately B former employees died in State 3 while covered by Corporation's policies and Corporation received C in death benefits payable under these policies upon the deaths of the insured. Decedent was an insured employee of Corporation which received a death benefit in the amount of D after his death in Year 1.

After discovering that the policy on Decedent existed, the Decedent's estate brought suit against Corporation in Year 3, claiming that Corporation did not have an insurable interest in the life of the Decedent and therefore, was not the rightful beneficiary of the policy on his life. In the action against Corporation, the Decedent's estate requested certification of a class consisting of former Corporation employees or their estates. The case was brought in the United States District Court (Court) certified a Settlement Class consisting of the estates or heirs of Corporation associates whose

lives were insured under COLI policies purchased by Corporation and who died in State 3 while those policies were in force, excluding those who were officers of Corporation at their death.

At some time during the course of the litigation, Corporation and the representative of the certified Settlement Class negotiated a settlement with Corporation which agreed to pay the amount of E into a settlement fund established for the benefits of the members of the Settlement Class, in exchange for release and discharge of any and all claims against Corporation or any of its current or former directors, officers, employees, attorneys, accountants, agents, subsidiaries, parents, affiliates, insurers, insurance brokers, co-insurers, heirs, executors, administrators, predecessors, successors, assignees, financial advisors, banks, investment bankers, underwriters, representatives, associates, trustees, general and limited partners and partnerships, consultants, auditors, divisions, joint ventures, related or affiliated entities, and entities in which Corporation has or had a controlling interest. This Settlement Agreement was approved by the Court in a final order issued on Date 1.

The Settlement Agreement requires counsel for the Settlement Class to establish a trust with a bank to receive and hold the Class Fund, i.e., amounts received from Corporation pursuant to the Settlement Agreement. The Class Fund is to be distributed to the members of the Settlement Class that have complied with the requirements for establishing valid claims. Pursuant to the final order of the Court, a valid claim is one that (1) relates to a former employee of Corporation who died in State 3 while covered by one of Corporation's COLI policies; (2) is supported by an order appointing the estate's executor or administrator, a declaration of heirship, or the affidavit of heirship described in the order; and (3) is postmarked on or before the last day of the claim period. The final order also states the Court's intent that each claimant be paid an appropriate proportion of the Settlement Fund based on the face amount of the COLI policy on the individual worker as a percentage of the aggregate face amounts of the COLI policies on all workers for whom a claim is made.

REQUESTED RULING

Representatives for the Decedent's estate and the Settlement Class (Taxpayers) request a ruling that the amounts distributed from the Class Fund to the Decedent's estate and members of the Settlement Class are non-taxable death benefit proceeds pursuant to section 101 of the Code.

LAW AND ANALYSIS

Section 61 of the Code provides that except as otherwise provided in Subtitle 1, gross income means all income from whatever source derived including, in subsection (a)(10), income from life insurance and endowment contracts. However, section 101(a)

of the Code provides an exclusion from gross income for amounts received under a life insurance contract, if such amounts are paid by reason of the death of the insured.

In the instant case, the Taxpayers claim that the amounts distributed from the Class Fund to the Decedent's estate and Settlement Class members are excluded from gross income because such amounts are proceeds from life insurance policies that are being paid by reason of the death of insured persons. Taxpayers argue that Corporation erroneously received the proceeds from the life insurance policies upon the deaths of employees covered by the COLI policies because under State 3 law, Corporation lacked an insurable interest in those employees' lives. Additionally, State 3 law provides that even though Corporation lacked an insurable interest in the employees' lives, the insurance contracts remained valid, and Corporation was required to hold the insurance proceeds in trust for the rightful beneficiaries of the policies, *i.e.*, the estates and heirs of the deceased employees. Taxpayers' assert that under the origin of the claim doctrine that was first enunciated in U.S. v. Gilmore, 372 U.S. 39, (1963), the proceeds distributed from the Class Fund retain the character of insurance proceeds received by reason of death and therefore, are excludable from income pursuant to section 101 of the Code.

In U.S. v. Gilmore, *supra*, the Supreme Court determined that expenses incurred in connection with a divorce proceeding were not deductible by the taxpayer because the expenses were not incurred for the conservation of property held for the production of income. In so holding, the Court stated that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was "business" or "personal" and hence whether or nor it is deductible . (372 U.S. at 44-51). Thus, the doctrine was first utilized to determine the characterization of an expense deduction. Similarly, in Boagni v. Commissioner, 59 T.C. 708 (1973), the issue before the Tax Court involved the deductibility of an expense item. In describing the origin of the claim doctrine, the Tax Court stated that the rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose. Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertinent to the controversy. (59 T.C. at 713).

In the litigation that gave rise to Taxpayers' claims, the District Court held that under State 3 law, the insurance contracts between Corporation and Company's 1 and 2 were valid, even though Corporation lacked an insurable interest in the lives of its employees covered by the COLI policies. In these circumstances, the life insurance proceeds received by Corporation upon the deaths of the covered employees clearly were proceeds paid by reason death. Had the Court invalidated the insurance contracts, the outcome likely would have been quite different, with Company's 1 and 2

having had to return the premiums paid by Corporation pursuant to the contracts. That result, of course, would have had no impact on the Taxpayers in any way whatsoever. By determining that the insurance contracts were valid under State 3 law, the Court provided Taxpayers a legal means for claiming the monies received by Corporation.

The Court's decision effectively permitted Taxpayers to sue for monies improperly converted by another party, i.e., Taxpayers' recovery is that of funds that were, in effect, converted by Corporation.

The amounts Taxpayers' recovered were pursuant to a settlement of the claims raised in the litigation to recover converted funds. The facts indicate that the Settlement Fund of amount E, is approximately one third of amount C, which was paid to Corporation under the policies. Amount E was paid by Corporation in consideration for Taxpayers' total release of any and all present or future claims against Corporation arising with respect to the COLI arrangement. The amounts paid to individual members of the Settlement Class were not the amount of death benefit under the individual policies, but rather were an appropriate proportion of the Settlement Fund based on the face amount of the COLI policy on the individual worker as a percentage of the aggregate face amounts of the COLI policies on all workers for whom a claim is made. The totality of these facts belies the Taxpayers' assertions that the amounts distributed from the Class Fund were insurance proceeds paid by reason of death. These amounts were paid to settle litigation that was brought long after the COLI policies' death benefits had been paid to Corporation.

HOLDING

The amounts distributed to the Taxpayers from the Class Fund are not excludable from gross income under section 101 of the Code.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. 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.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

/S/

Donald J. Drees, Jr.,
Acting Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)