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Date:

November 13, 2003

Legend:

Insurer
Keyman

State
X Corp

Dear :

This is in response to a request for ruling submitted on the behalf of X Corp, a corporation organized under the laws of State, concerning the accrual of life insurance proceeds. X Corp is an "S corporation" as that term is defined in section 1361(a) of the Internal Revenue Code. X Corp uses the accrual method of accounting.

The minority shareholders of X Corp, acting through a limited liability company they own, acquired a life insurance policy on the Keyman to provide funds for the redemption from the Keyman's estate, pursuant to an agreement among X Corp and all of its shareholders, of the X stock owned by the Keyman at the time of his death. The limited liability company proposes to transfer ownership of the insurance policy to X Corp. The limited liability company will be liquidated after the transfer to X Corp of the life insurance policy, which is its only asset.

The ruling request did not include a copy of the insurance policy. However, a letter from the Insurer describes the manner in which it processes a typical life insurance claim. Upon notice of the death of an insured, the Insurer requests a certified

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copy of the death certificate and a Beneficiary's Statement from the named beneficiary(ies). Upon the Insurer's receipt of the certified death certificate and

Beneficiary's Statement, the Insurer processes the claim for payment. The letter lists a number of items that could influence the amount of the payment due a beneficiary: (1) interest from the date of the insured's death, (2) refund of unused premium, (3) prorated dividends, and (4) offset of outstanding loans. Although the items may impact the amount of a payment to a beneficiary, they do not impact the time at which a beneficiary obtains a right to the insurance proceeds.

The Insurer's letter indicates that thorough investigations become necessary in certain infrequent circumstances, e.g., death within the contestable period (the first two years after the policy is issued), suicide within the policy's first two years, fraudulent claims, or claims by competing adverse beneficiaries. In such cases, payment of a claim may be delayed or denied. None of the described circumstances are relevant in this case as the insurance policy is beyond the two year contestable period, the suicide exclusion no longer applies, and X Corp is/will be the sole owner and beneficiary of the policy.

Upon the death of the Keyman, X Corp plans to immediately redeem the X Corp stock held by the Keyman at the time of his death by issuance of a promissory note to the Keyman's estate. After the redemption, the remaining shareholders of X Corp intend to make an election, pursuant to section 1377(a)(2) of the Code, to terminate X Corp's taxable year. By terminating X Corp's taxable year after the redemption of the Keyman's stock but prior to submission of a claim on the life insurance policy on the Keyman's life, the remaining shareholders seek to have all of the insurance proceeds allocated to their X Corp stock.

X Corp requests a ruling that the life insurance proceeds will not be recognized or affect the shareholders' basis in their X Corp stock under section 1367 until the insurance company acknowledges the validity of X Corp's claim under the insurance policy.

Section 1366(a)(1)(A) provides that in determining the income tax of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies, or of a trust or estate which terminates, before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and nonseparately computed income or loss.

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Section 1367(a) provides, in part, that the basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the items described in section 1366(a)(1), any nonseparately computed income determined under section 1366(a)(1)(B), and the excess of the deductions for depletion over the basis of the property subject to depletion.

Section 1.1367-1(d)(2) of the Income Tax Regulations provides that an adjustment to a shareholder's basis of S corporation stock for nontaxable items is determined for the taxable year in which the item would have been includible or deductible under the corporation's method of accounting for federal income tax purposes if the item had been subject to federal income taxation.

Section 1.451-1(a) provides that under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

A number of cases have concluded that accrual of income from the sale of goods is not required if the right to receive that income is subject to one or more conditions precedent or other contingencies. Ringmaster, Inc. v. Commissioner, T.C. Memo. 1962-187, dismissed per curiam, 319 F.2d 860 (8th Cir. 1963) (income not required to be accrued prior to purchaser's acceptance as satisfying specifications); Webb Press Co. Ltd. v. Commissioner, 3 B.T.A. 247 (1925), acq. VI-I C.B. 6 (accrual not required until acceptance after testing); Florence Mills, Inc. v. Commissioner, 9 B.T.A. 579 (1927), acq. VII-I C.B. 11 (accrual not required where purchaser rejected goods); Rev. Rul. 70-68, 1970-1 C.B. 122 (accrual not required for goods sold on COD terms).

A right to income that is contested is not required to be accrued prior to resolution of the dispute concerning the amount. Rev. Rul. 73-385, 1973-2 C.B. 151 (accrual of state sales and use tax refund not required until year in which state took affirmative action); Rev. Rul. 60-237 1960-2 C.B. 164 (accrual of disputed increase in per diem rental of railroad freight cars not required until dispute resolved). The complexity of the tax laws and the potential for different interpretations of the relevant statutes warrants deferral of accrual of a state income tax refund until affirmative action is taken with respect to the claim. In contrast to such review, the Insurer's letter indicates that a life insurance claim is typically paid upon receipt of a certified death certificate and a Beneficiary's Statement.

In circumstances involving an agreement for the performance of services, the performance of the services is, generally, the event that establishes the fact of liability on the part of the service recipient and the service provider's right to receive income. See, e.g., National Bread Wrapping Machine Co. v. Commissioner, 30 T.C. 550 (1958), (performance of services pursuant to a contract necessary to establish the taxpayer's liability).

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The existence of a contractual requirement for the submission of a claim or other documentation to obtain payment does not delay the establishment of the fact of liability

under the all events test if such act is ministerial. See Dally v. Commissioner, 227 F.2d 724 (9th Cir. 1955), cert. denied, 351 U.S. 908 (1956) (contractor's right to income was fixed in the year it delivered houses, not in later year when a properly certified invoice was submitted, even though the contract specifically provided for payment upon the submission of a properly certified invoice); Frank's Casing Crew & Rental Tools, Inc. v. Commissioner, T.C. Memo. 1996-413 (contractor's preparation and submission of invoices were ministerial acts that did not postpone accrual of income otherwise earned). See also Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932) (ICC function to ascertain facts and make comparisons was ministerial where the Transportation Act provided for awards to railroads that competed for traffic or connected with a railroad under federal control. Rev. Rul. 98-39, 1998-2 C.B. 198 (manufacturer's liability to retailer for cooperative advertising services incurred in the year the services are performed though required claim not submitted until subsequent year); Charles Schwab v. Commissioner, 107 T.C. 282 (1996) (broker's execution of customer order establishes the broker's right to receive commission income).

In United States v. General Dynamics Corp., 481 U.S. 239 (1987), the Supreme Court denied a corporation's deduction for its estimated liability for reimbursement of employees' payments for medical services provided under medical plans administered by private firms hired by the corporation. Although the Supreme Court held that the filing of a claim by an employee was necessary to establish the corporation's liability, it did not overturn the lower court's conclusion that the processing of claims was ministerial in nature. The submission of a claim was considered significant as employees who sought to avoid disclosing to the employer the nature of the medical services received would not submit a claim and the employer would never incur a liability for reimbursement. Claims with respect to life insurance policies do not present such considerations since the insured is not the beneficiary. The responsibilities of an executor of a decedent's estate would include filing a claim on any life insurance policies owned by the decedent. A beneficiary who had knowledge of his or her status as a beneficiary would have an economic interest in ensuring that a claim was filed.

The circumstances concerning the accrual of proceeds of X Corp's life insurance policy on its Keyman are more analogous to those in Frank's Casing Crew & Rental Tools, Inc., Continental Tie & Lumber Co., Charles Schwab, and Rev. Rul. 98-39 than those in the cases involving the provision of goods subject to inspection, testing, and acceptance by the purchaser. The performance of the contracted service established the basis for accrual of income despite a requirement for various ministerial acts, e.g., submission of an invoice, review of data, performance of back office administrative duties concerning a stock trade, or submission of a claim. The submission of a claim on

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the Keyman policy held by X Corp would be a ministerial act. Based on the information provided concerning X Corp's circumstances and the policy, the insurance company would have no discretion to deny the claim. The policy is beyond the two-year contestable period and the period for exclusion of benefits as a result of suicide of the insured. The fact that X Corp will be the sole owner of the policy and be the sole named beneficiary of the policy will preclude any adverse claims by other purported beneficiaries. Accordingly, none of the potential circumstances that could require a thorough investigation before payment or provide a basis for denial of a claim on the policy exist. The calculation of interest, the amount of a premium refund, etc. are ministerial acts similar to those in Continental Tie & Lumber Co.

Based on the information provided, the life insurance proceeds on X Corp's insurance policy on the Keyman will be required to be recognized as of the date of the Keyman's death. In the circumstances described, the Keyman's death will establish X Corp's rights to the proceeds as a beneficiary of the insurance policy.

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

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

Pursuant to the power of attorney on file in this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Douglas A. Fahey
Special Assistant to the Associate
Chief Counsel
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: