Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: James C. Fee, Jr.
Senior Level Counsel
(Large Business & International)

from: John P. Moriarty
Associate Chief Counsel
(Income Tax & Accounting)

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subject: Deductibility of Certain "Tax Insurance" Premiums

This memorandum addresses the deductibility of certain “tax insurance”[1] premiums under sections 162(a) and 212 of the Internal Revenue Code.

QUESTION PRESENTED

Can a partnership deduct the cost of premiums paid for an insurance policy that contemplates reimbursing the partners for an adjustment that reduces the tax benefits they are entitled to claim for a charitable contribution made by the partnership (i.e., a “tax insurance” policy)?

LAW AND ANALYSIS

A. Section 162(a)

Section 162(a) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section § 1.162–1(a) of the Income Tax Regulations provides that deductible trade or business expenses

[1] Whether the “tax insurance” described in this memorandum constitutes insurance for federal income tax purposes is beyond the scope of this memorandum. Consequently, the use of such terms as “insurance,” “policy,” and “premium” is for linguistic economy only and should not be regarded as indicating or recommending a legal conclusion with respect to this or any related question.

include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.

Whether an expense is deductible under section 162(a) is determined at the level of the partnership. See Brannen v. Commissioner, 78 T.C. 471, 502–05 (1982) (discussing Madison Gas & Electric Co. v. Commissioner, 72 T.C. 521, 564–65 (1979), aff'd 633 F.2d 512 (7th Cir. 1980); Goodwin v. Commissioner, 75 T.C. 424, 434–39 (1980)).

Where an expense involves a contractual arrangement for reimbursement in the event of specified contingencies, the terms of the arrangement determine whether the expense is sufficiently related to activities recognized under section 162(a) to support a deduction. Rev. Rul. 55-264; Rev. Rul. 58-480; Blaess v. Commissioner, 28 T.C. 710, 714–15 (1957).

The "tax insurance" premiums described above are not sufficiently related to the partnership's trade or business to support a deduction under section 162(a). In the event of an adjustment to a deduction claimed for a charitable contribution, the policy will reimburse the partners for any difference between the tax benefits they claimed and the tax benefits they are entitled to receive, regardless of any trade or business activity of the partnership. For this reason, the partnership may not deduct its "tax insurance" premiums under section 162(a).

B. Section 212(1)–(2)

Section 212(1)–(2) allows individuals to deduct ordinary and necessary expenses paid or incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. Section 1.212–1(d) provides that, to be deductible under section 212, an expense must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

Sections 162(a) and 212 are generally considered in pari materia, and the restrictions and qualifications applicable to the deductibility of trade or business expenses are also applicable to income-production expenses covered by section 212(1)–(2). See United States v. Gilmore, 372 U.S. 39, 45 (1963). Consequently, the deductibility under section 212(1)–(2) of an expense involving a contractual arrangement for reimbursement is determined by the terms of the arrangement. See Rev. Rul. 55-264; Rev. Rul. 58-480; Blaess, 28 T.C. at 714–15.

The “tax insurance” premiums described above are not sufficiently related to the partnership’s income-producing activities to support a deduction under section 212(1)–(2). In the event of an adjustment to the deduction claimed under section 170, the policy will reimburse the partners for any difference between the tax benefits they claimed and the tax benefits they are entitled to receive, regardless of any income producing activity of the partnership. For this reason, the partnership may not deduct its “tax insurance” premiums under section 212(1)–(2).

C. Section 212(3)

Section 212(3) allows the deduction of expenses related to the determination, collection, or refund of any tax. Section 1.212–1(l) provides that expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of his tax liability or in contesting his tax liability are deductible.

Section 275 prohibits the deduction of federal income taxes.

The “tax insurance” premiums described above are not deductible as an expense related to the determination, collection, or refund of any tax under section 212(3). The policy does not provide, fund, or reimburse any services or materials related to preparing returns, determining a tax liability, or contesting such liability; it reimburses the partners for their minimum proper federal income tax, an amount not deductible under section 275. For this reason, the partnership may not deduct its “tax insurance” premiums under section 212(3).

CONCLUSIONS

For the reasons given above, the “tax insurance” premiums described above are not deductible under sections 162(a) or 212. Please call (202) 317-3225 if you have any questions.