

§ 1.264-4

§ 1.264-4 Other life insurance, endowment, or annuity contracts.

(a) *General rule.* Except as otherwise provided in paragraphs (d) and (e) of this section, no deduction shall be allowed under section 163 or any other provision of chapter 1 of the Code for any amount (determined under paragraph (b) of this section) paid or accrued during the taxable year on indebtedness incurred or continued to purchase or continue in effect a life insurance, endowment, or annuity contract (other than a single premium contract or a contract treated as a single premium contract) if such indebtedness is incurred pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract (either from the insurer or otherwise). For the purposes of the preceding sentence, the term of purchase includes the payment of part or all of the premiums on a contract, and not merely payment of the premium due upon initial issuance of the contract. The rule of this paragraph applies whether or not the taxpayer is the insured, payee, or annuitant under the contract, the rule of this paragraph does not apply to contracts purchased by the taxpayer on or before August 6, 1963, even though there is a substantial increase in premiums after such date. The rule of this paragraph does not apply to any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract (including a contract treated as a single premium contract); the treatment of such amounts is governed by § 1.264-2.

(b) *Determination of amount not allowed.* The amount not allowed as a deduction under paragraph (a) of this section is determined with reference to the entire amount of borrowing to purchase or carry the contract, and is not limited with reference to the amount of borrowing of increases in the cash value. The rule of this paragraph may be illustrated by the following example:

Example. A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, on January 1, 1964, purchases from a life insurance company a policy in

the amount of \$100,000 with an annual gross premium of \$2,200. For the first policy year, A pays the annual premium by means other than by borrowing. For the second, third, fourth, and fifth policy years, A continues the policy in effect by incurring indebtedness pursuant to a plan referred to in paragraph (a) of this section. The years and amounts applicable to the policy are as follows:

Years	Cumulative cash value of contract	Total loan outstanding	Interest paid at 4.8 percent
1964	\$370	0	0
1965	2,175	\$2,200	\$105.60
1966	4,000	4,400	211.20
1967	5,865	6,600	316.80
1968	7,745	8,800	422.40

On these facts (assuming that none of the exceptions contained in paragraph (d) of this section are applicable), no deduction is allowed for the interest paid during the year 1968. Moreover, the interest deduction will be disallowed for the taxable years 1965 through 1967 if such taxable years are not closed by reason of the statute of limitations or other rule of law.

(c) *Special rules.* For purposes of this section:

(1) *Determination of existence of a plan which contemplates systematic borrowing—(i) In general.* The determination of whether indebtedness is incurred or continued pursuant to a plan referred to in paragraph (a) of this section shall be made on the basis of all the facts and circumstances in each case. Unless the taxpayer shows otherwise, in the case of borrowing in connection with premiums for more than three years, the existence of a plan referred to in paragraph (a) of this section will be presumed. The mere fact that a taxpayer does not borrow to pay a premium in a particular year does not in and of itself preclude the existence of a plan referred to in paragraph (a) of this section. A plan referred to in paragraph (a) of this section need not exist at the time the contract is entered into, but may come into existence at any time during the 7-year period following the taxpayer's purchase of the contract or following a substantial increase (referred to in paragraph (d)(1) of this section) in premiums on the contract.

(ii) *Premium attributable to more than one year.* For purposes of subdivision (i)

of this subparagraph, if the stated annual premiums due on a contract vary in amount, borrowing in connection with any premium, the amount of which exceeds the amount of any other premium, on such contract may be considered borrowing to pay premiums for more than one year. The preceding sentence shall not apply where the borrowing is in connection with a substantially increased premium within the meaning of paragraph (d)(1) of this section.

(2) *Direct or indirect.* A plan referred to in paragraph (a) of this section may contemplate direct or indirect borrowing of increases in cash value of the contract directly or indirectly to pay premiums and may contemplate borrowing either from an insurance carrier, from a bank, or from any other person. Thus, for example, if a taxpayer borrows \$100,000 from a bank and uses the funds to purchase securities, later borrows \$100,000 from a second bank and uses the funds to repay the first bank, later sells the securities and uses the funds as a part of a plan referred to in paragraph (a) of this section to pay premiums on a contract of cash value life insurance, the deduction for interest paid in continuing the loan from the second bank shall not be allowed (assuming that none of the exceptions contained in paragraph (d) of this section are applicable). Moreover, a plan referred to in paragraph (a) of this section need not involve a pledge of the contract, but may contemplate unsecured borrowing or the use of other property.

(d) *Exceptions.* No deduction shall be denied under paragraph (a) of this section with respect to any amount paid or accrued during a taxable year on indebtedness incurred or continued as part of a plan referred to in paragraph (a) of this section if any of the following exceptions apply.

(1) *The 7-year exception—(i) In general.* No part of 4 of the annual premiums due during the 7-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness. For purposes of this exception, in the event of a substantial increase in any annual premium on a contract, a new 7-year pe-

riod begins on the date such increased premium is paid. If premiums on a contract are payable other than on an annual basis (for example, monthly), the annual premium is the aggregate of premiums due for the year. See paragraph (c)(1)(ii) of this section for cases where one premium on a contract paid by means of indebtedness may be considered as more than one annual premium.

(ii) *Application of borrowings.* For purposes of subdivision (i) of this subparagraph, if during a 7-year period referred to in such subdivision the taxpayer, directly or indirectly, borrows with respect to more than one annual premium on a contract, such borrowing shall be considered first attributable to the premium for the current policy year (within the meaning of subdivision (iii) of this subparagraph) and then attributable to premiums for prior policy years beginning with the most recent prior policy year (but not including any prior policy year to the extent that such taxpayer has indebtedness outstanding with respect to the premium for such prior policy year). If such borrowing exceeds the premiums paid for the current policy year and for prior policy years and the taxpayer has, with respect to the current policy year, deposited premiums in advance of the due date of such premiums, such excess borrowing shall be considered indebtedness incurred to carry the contract which is attributable to the premiums deposited for succeeding policy years beginning with the premium for the next succeeding policy year. The preceding sentence shall not apply to a single premium contract referred to in § 1.264-2.

(iii) *Current policy year.* For purposes of subdivision (ii) of this subparagraph, the term *current policy year* refers to the policy year which begins with or within the taxable year of the taxpayer.

(iv) *Illustrations.* The provisions of subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer using the cash receipts and disbursements method of accounting, on January 1, 1964, purchases from a life insurance company a

policy in the amount of \$100,000 with an annual gross premium of \$2,200. For the first four policy years, A initially pays the annual premium by means other than borrowing. On January 1, 1968, pursuant to a plan referred to in paragraph (a) of this section, A borrows \$10,000 with respect to the policy. Such borrowing is considered first attributable to paying the premium for the year 1968 and then attributable to paying the premiums for the years 1967, 1966, 1965, and 1964 (in part). No deduction is allowed for the interest paid by A on the \$10,000 indebtedness during the year 1968.

Example 2. The facts are the same as in *Example 1*, except that on January 1, 1964, A pays the first annual premium and deposits an amount equal to the second and third annual premiums, all such amounts initially being paid or deposited by means other than borrowing. On January 1, 1965, A deposits an amount equal to the fourth, fifth, and sixth annual premiums, and borrows \$4,400 pursuant to a plan referred to in paragraph (a) of this section. Such borrowing is considered attributable to the premiums paid for the policy years 1965 and 1964. On January 1, 1966, A deposits an amount equal to the seventh, eighth, and ninth annual premiums, and borrows \$6,600 pursuant to such plan. Such borrowing is considered attributable to the premium paid for the policy year 1966 and deposited for the policy years 1967 and 1968. No deduction is allowed for interest paid by A on the \$11,000 indebtedness during 1966. Moreover, the interest deduction will be disallowed for the taxable year 1965. However, if this contract is treated as a single premium contract under § 1.264-2 (by reason of deposit with the insurer of an amount for payment of a substantial number of future premiums), the deduction for interest on indebtedness incurred or continued to purchase or carry the contract would be denied without reference to this section.

(2) *The \$100 exception.* The total amount paid or accrued during the taxable year by the taxpayer who has entered one or more plans referred to in paragraph (a) of this section for which (without regard to this subparagraph) no deduction would be allowable under paragraph (a) of this section does not exceed \$100. Where the amount so paid or accrued during the taxable year exceeds \$100, the entire amount shall be subject to the general rule of paragraph (a) of this section.

(3) *The unforeseen events exception.* The amount is paid or accrued by the taxpayer on indebtedness incurred because of an unforeseen substantial loss of such taxpayer's income or an unforeseen substantial increase in such tax-

payer's financial obligations. A loss of income or increase in financial obligations is not unforeseen, within the meaning of this subparagraph, if at the time of the purchase of the contract such event was or could have been foreseen. College education expenses are foreseeable; however, if college expenses substantially increase, then to the extent that such increases are unforeseen, this exception will apply. This exception applies only if the plan referred to in paragraph (a) of this section arises because of the unforeseen event. Thus, for example, if a taxpayer or his family incur substantial unexpected medical expenses or the taxpayer is laid off from his job, and for that reason systematically borrows against the cash value of a previously purchased contract, the deduction for the interest paid on the loan will not be denied, whether or not the loan is used to pay a premium on the contract.

(4) *The trade or business exception.* The indebtedness is incurred by the taxpayer in connection with his trade or business. To be within this exception, the indebtedness must be incurred to finance business obligations rather than to finance cash value life insurance. Thus, if a taxpayer pledges a life insurance, endowment, or annuity contract as part of the collateral for a loan to finance the expansion of inventory or capital improvements for his business, no part of the deduction for interest on such loan will be denied under paragraph (a) of this section. Borrowing by a business taxpayer to finance business life insurance such as under so-called keyman, split dollar, or stock retirement plans is not considered to be incurred in connection with the taxpayer's trade or business within the meaning of this subparagraph. The determination of whether the indebtedness is incurred in connection with the taxpayer's trade or business, within the meaning of this exception, rather than to finance cash value life insurance shall be made on the basis of all the facts and circumstances. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. Corporation M each year borrows substantial sums to carry on its business. Corporation M agrees to provide a retirement plan for its employees and purchases level premium life insurance to fund its obligation under the plan. The mere fact that M Corporation purchases a cash value life insurance policy will not cause its deduction for interest paid on its normal indebtedness to be denied even though the policy is later used as part of the collateral for its normal indebtedness.

Example 2. Corporation R has \$200,000 of bonds outstanding and purchases cash value life insurance policies on several of its key employees. Such purchase by R Corporation will not, of itself, cause its deduction for interest on its bonded indebtedness to be denied. If, however, the premiums on the life insurance policies are \$10,000 each year, the cash value increases by \$8,000 each year, and R Corporation increases its indebtedness by \$10,000 each year, its deduction for interest on such indebtedness will not be allowed under the rule of paragraph (a) of this section. On the other hand, the absence of such a directly parallel increase will not of itself establish that the deduction for interest is allowable.

(e) *Applicability of section.* The rules of this section apply with respect to taxable years beginning after December 31, 1963, but only with respect to contracts purchased after August 6, 1963. With respect to contracts entered into on or before August 6, 1963, but purchased or acquired whether from the insurer, insured, or any other person (other than by gift, bequest, or inheritance, or in a transaction to which section 381(a) of the Code applies) after such date, the rules of this section apply after such purchase or acquisition.

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§ 1.265-1 Expenses relating to tax-exempt income.

(a) *Nondeductibility of expenses allocable to exempt income.* (1) No amount shall be allowed as a deduction under any provision of the Code for any expense or amount which is otherwise allowable as a deduction and which is allocable to a class or classes of exempt income other than a class or classes of exempt interest income.

(2) No amount shall be allowed as a deduction under section 212 (relating to expenses for production of income) for any expense or amount which is otherwise allowable as a deduction and

which is allocable to a class or classes of exempt interest income.

(b) *Exempt income and nonexempt income.* (1) As used in this section, the term *class of exempt income* means any class of income (whether or not any amount of income of such class is received or accrued) wholly exempt from the taxes imposed by Subtitle A of the Code. For purposes of this section, a class of income which is considered as wholly exempt from the taxes imposed by subtitle A includes any class of income which is:

(i) Wholly excluded from gross income under any provision of Subtitle A, or

(ii) Wholly exempt from the taxes imposed by Subtitle A under the provisions of any other law.

(2) As used in this section the term *nonexempt income* means any income which is required to be included in gross income.

(c) *Allocation of expenses to a class or classes of exempt income.* Expenses and amounts otherwise allowable which are directly allocable to any class or classes of exempt income shall be allocated thereto; and expenses and amounts directly allocable to any class or classes of nonexempt income shall be allocated thereto. If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each.

(d) *Statement of classes of exempt income; records.* (1) A taxpayer receiving any class of exempt income or holding any property or engaging in any activity the income from which is exempt shall submit with his return as a part thereof an itemized statement, in detail, showing (i) the amount of each class of exempt income, and (ii) the amount of expenses and amounts otherwise allowable allocated to each such class (the amount allocated by apportionment being shown separately) as required by paragraph (c) of this section. If an item is apportioned between a class of exempt income and a class of nonexempt income, the statement shall show the basis of the apportionment. Such statement shall also recite that