Rugby Productions Ltd. v. Commissioner, 100 T. C. 531, 1993 U. S. Tax Ct. LEXIS 35, 100 T. C. No. 35, 16 Employee Benefits Cas. (BNA) 2722 (1993)

Insurance premiums paid by a corporation for disability income insurance, where the proceeds are payable to the corporation and thus tax-exempt, are not deductible under I. R. C. § 265(a)(1).

Summary

Rugby Productions Ltd. , a personal service corporation owned by Joan Rosenberg and her late husband, purchased a high-limit disability income insurance policy on Joan Rosenberg, its key employee, from Lloyd's of London. The policy named Rugby as the beneficiary. Rugby sought to deduct the premiums paid, arguing they were part of Joan's compensation package. The Tax Court held that the premiums were not deductible under I. R. C. § 265(a)(1) because any proceeds would be tax-exempt income to Rugby under I. R. C. § 104(a)(3). The court found no evidence that the policy was part of Joan's compensation or that she had a legal right to the proceeds. However, the court did not impose the negligence penalty under I. R. C. § 6653.

Facts

Rugby Productions Ltd. , a Delaware corporation, was a personal service corporation wholly owned by Joan Rosenberg and her deceased husband, Edgar Rosenberg. Joan was Rugby's key employee and a professional entertainer. On July 29, 1986, Rugby applied for and obtained a high-limit monthly disability income insurance policy from Lloyd's of London on Joan, effective for three years starting August 8, 1986. Rugby was named the "assured" and beneficiary, while Joan was the "insured person. " The policy would pay $75,000 per month for 60 months if Joan became temporarily totally disabled. Rugby paid premiums totaling $115,492 during the tax year in question, which it sought to deduct. Rugby's board adopted resolutions to establish an insured accident and sickness plan under I. R. C. §§ 105 and 106, but the record was silent on the specifics of Joan's employment contract or any contracts with third parties for her services.

Procedural History

The Commissioner of Internal Revenue issued a notice of deficiency to Rugby on March 15, 1991, disallowing the deduction of the insurance premiums and asserting additions to tax for negligence and substantial understatement of income tax. Rugby petitioned the U. S. Tax Court for redetermination. The case was submitted fully stipulated, and the Tax Court rendered its opinion on June 14, 1993, disallowing the deduction but not imposing the negligence penalty.

Issue(s)

1. Whether Rugby Productions Ltd. may deduct the premiums paid on the disability income insurance policy insuring Joan Rosenberg under I. R. C. § 162(a)?

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2. Whether Rugby is liable for the addition to tax for negligence under I. R. C. § 6653?

Holding

1. No, because the premiums were allocable to tax-exempt income under I. R. C. § 265(a)(1), as any proceeds would have been excludable from Rugby's gross income under I. R. C. § 104(a)(3).
2. No, because there was no basis for imposing the negligence penalty under I. R. C. § 6653.

Court's Reasoning

The court applied I. R. C. § 265(a)(1), which disallows deductions for expenses allocable to tax-exempt income other than interest. Since the policy named Rugby as the beneficiary, any proceeds would have been tax-exempt under I. R. C. § 104(a)(3). The court rejected Rugby's argument that the premiums were part of Joan's compensation package, noting the lack of evidence that the policy was integrated into her employment contract or that she had a legal right to the proceeds. The court distinguished Revenue Ruling 58-90, which allowed deductions for premiums on policies where the employee was the beneficiary, from the facts of this case. The court also cited Revenue Ruling 66-262, which disallowed deductions for premiums on policies where the employer was the beneficiary. The court found no evidence of negligence justifying the imposition of the penalty under I. R. C. § 6653.

Practical Implications

This decision clarifies that premiums paid by an employer for disability insurance are not deductible if the employer is the beneficiary and the proceeds would be tax-exempt under I. R. C. § 104(a)(3). Corporations must carefully structure such policies to ensure the employee is the legal beneficiary if they wish to deduct the premiums as compensation. The case underscores the importance of clear documentation of employment terms and the integration of insurance policies into compensation packages. Subsequent cases have cited Rugby Productions in addressing similar issues of premium deductibility and the application of I. R. C. § 265(a)(1). For businesses, this ruling highlights the need to consider tax implications when purchasing insurance on key employees and the potential for non-deductible expenses if not properly structured.

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