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Experience Rating, *Helvering vs. Le Gierse*, and COLI/BOLI Arrangements

by Kirk Van Brunt

Almost 65 years ago, the Supreme Court issued its opinion in *Helvering v. Le Gierse*,[1] addressing when an arrangement should be recognized as involving "insurance" for federal income tax purposes. According to the Court, an "insurance risk" must be present, and for an insurance risk to exist, there must be "risk-shifting and risk distribution."[2] In reading the opinion, one senses that the court thought that it was merely stating the obvious. If the court had been able to peer into the future, it probably would have been surprised to see the critical significance that those two terms—"risk-shifting" and "risk distribution"—would take on under the tax laws, and how much time and effort taxpayers, the IRS and courts would spend down through the years parsing out the meaning of those two terms. Yet, those two terms continue to dominate the tax analysis of whether an arrangement is insurance or not.[3]

Historically, most of the litigation over risk shifting and distribution has been in the property-casualty arena. It is less commonly raised as an issue with individual life insurance, particularly since the enactment of section 7702, except in situations where the facts are similar to those of *Le Gierse*.[4] In recent years, however, the IRS has been raising the issue of risk-shifting and risk distribution in its litigation over leveraged corporate-owned life insurance (COLI), where the policies in question provided for experience rating. The IRS has advanced the argument, with some success, that by virtue of the experience rating mechanism in a group of policies, the corporate policyholder is essentially paying its own death claims.[5] Although risk-shifting and risk distribution exists at the level of each individual policy considered in isolation, this is not the case in the aggregate with respect to the entire COLI arrangement, the IRS has argued.[6] The net effect of the total COLI arrangement is that there is no risk transfer; according to the IRS, the arrangement is "mortality neutral." The concept of mortality neutrality is a great deal reminiscent of *Le Gierse*: the annuity contract and life policy in *Le*

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[1] 312 U.S. 531 (1941).

[2] 312 U.S. at 539-40. In *Le Gierse*, an insurance company simultaneously issued a single premium, immediate life annuity contract and single premium life insurance policy to an individual. The one instrument would not have been issued without the other, and collectively the two operated to cancel out any mortality risk being shifted to the insurance company. Stated differently, the risk of loss from premature death shifted to the insurance company under the life insurance policy was exactly offset by the risk of loss from premature death shifted back to the policyholder under the annuity contract.

[3] Most recently, see, e.g., Rev. Rul. 2005-40, 2005-27 I.R.B. 4 (addressing the risk-distribution prong of the test where an insurer insures only one or a small number of independent risks).

[4] This is not to say that there are never any *Le Gierse* issues after the enactment of section 7702. There are, e.g., the issue can arise when an insured attains age 100 and the section 7702 "corridor" drops to zero. However, we leave for another day the question of how *Le Gierse* interacts with section 7702.

[5] See *American Elec. Power, Inc. v. United States*, 326 F.3d 737 (6th Cir. 2003), aff'g 136 F. Supp. 2d 762 (S.D. Ohio 2000), cert. denied 540 U.S. 1140 (2004); *IRS v. C.M. Holdings, Inc.*, 301 F.3d 96 (3d Cir. 2002), aff'g 254 B.R. 748 (D. Del. 2000); *Winn-Dixie Stores, Inc. v. Comm'r*, 254 F.3d 1313 (11th Cir. 2001), aff'g 113 T.C. 254 (1999), cert. denied, 535 U.S. 986 (2002). Cf. *Dow Chemical Company and Subsidiaries v. United States*, 250 F. Supp. 2d 748 (E.D. Mich.), modified in part upon reconsideration, 278 F. Supp. 2d 844 (2003) [Currently on appeal to the Sixth Circuit].

[6] See, e.g., American Elec. Power, supra note 5, at 326 F.3d at 742-43.

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Gierse each involved risk shifting and risk distribution when considered separately, but collectively the two contracts offset one another and there was no net transfer of risk—i.e., the annuity-life policy arrangement, considered in its entirety, was "mortality neutral."

While leveraged COLI lived a short life and died an inglorious death, the IRS's attack on mortality neutrality continues to be a source of concern for other COLI arrangements. There is an active and vigorous market for nonleveraged COLI and bank-owned life insurance (BOLI). COLI/BOLI remains an attractive investment vehicle for funding certain liabilities, such as employee benefit obligations. Often, however, these COLI/BOLI arrangements possess experience-rating mechanisms that, to varying degrees, aspire to achieve a measure of mortality neutrality. In the aftermath of the leveraged COLI litigation, concerns have deepened as to whether these traditional COLI/BOLI arrangements could be within reach of the long arm of *Le Gierse*. To be sure, in the leveraged COLI litigation, the IRS argued that the existence of mortality neutrality demonstrates that the arrangements are sham transactions, lacking in economic substance; the IRS did not specifically argue that the arrangements were not insurance under *Le Gierse*. Moreover, as a general matter, probably most practitioners in the area would not consider the typical traditional COLI/BOLI to be substantially susceptible to a sham transaction analysis. However, there is no indication that the IRS views its mortality neutrality argument as limited just to cases involving shams.

How should COLI/BOLI arrangements be structured in order to avoid the argument that they are not insurance under *Le Gierse* because of mortality neutrality? There are several points to consider in this regard (in no particular order):

- *Avoid experience rating altogether*. This would solve the problem, but unfortunately competitive and financial pressures within the COLI/BOLI marketplace may make this solution impractical.

- *Avoid formulaic experience rating*. The more experience credits or refunds are discretionary with the insurer, and the less they are contractually guaranteed or fixed by formula (either in the policies or via a side letter), the better. Unfortunately, this often means opposing the policyholder, whose natural inclination is to have everything contractually spelled out in as much detail as possible. This should be avoided. The insurer should retain some meaningful element of discretion regarding the payment of experience credits or refunds.

- *Steer clear of perfect mortality neutrality*. The *Le Gierse* case involved perfect mortality neutrality, but it probably should not be read as limited to only such situations. Accordingly, there should always be some meaningful, non-trivial mortality risk being shifted to the insurer. How much is enough? Opinions vary. This is the fundamental flaw with the *Le Gierse* risk-shifting/risk distribution analysis: it does not address the quantum of risk that must be shifted and distributed. For example, is it enough that the insurer is potentially at risk only in the event that mortality experience is worse than a stated maximum, such as 1980 CSO? Is it enough that the insurer is potentially at risk only in the event of a major catastrophe? Maybe, or maybe not. The only clear answer is the more risk, the better. Ideally, there should be a meaningful probability that the insurer will bear the loss from premature death.

- *Prospective vs. retrospective*. To date, the government's only loss in its leveraged COLI litigation was the *Dow Chemical* case.[7] One key fact cited by the Court in distinguishing Dow Chemical from the other leveraged COLI cases was that the experience rating mechanism operated on a prospective basis. The arrangement did not provide for a retrospective true-up mechanism.[8] Adhering to this distinction would be a good idea. Thus, as part of avoiding perfect mortality neutrality, retrospective true-up devices should be avoided if at all possible. Instead, past mortality experience should only be taken into account by adjusting prospective future charges or interest credits.

In summary, it is common for traditional, nonleveraged COLI/BOLI arrangements to provide for some form of experience rating. However, in the wake of the IRS's mortality neutrality argument in the leveraged COLI litigation, concerns exist as to whether this argument could be turned against traditional COLI/BOLI arrangements to assert that they do not constitute insurance under the risk-shifting/risk distribution standard of *Le Gierse*. For this reason, insurers may want to take affirmative steps to structure experience rating mechanisms so as to reduce the risk of a mortality neutrality argument.

Kirk Van Brunt is a partner with the Washington, DC law firm of Davis & Harman LLP. He may be reached at *kvbrunt@davis-harman.com*.

[7] See Dow Chemical, supra note 5. It should be noted, however, that the case is on appeal to the Sixth Circuit, which has not yet rendered a decision as of the date this article went to press.

[8] See Dow Chemical, supra note 5, at 779-80, 782.