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COLI Update

COLI products continue to be the focus of litigation. The following two articles provide updates on two current COLI cases and their most recent court decisions. The first concerns a District Court's ruling on insurable interest, while the latter provides an update of the Sixth Circuit reversal of a trial court decision.

Court Decides Xcel Had Insurable Interest In Broad-Based COLI

by Peter H. Winslow and Susan J. Hotine

In addition to arguing sham and lack of economic substance, the IRS has begun attacking interest deductions on broad-based COLI programs by stating that the employer did not have an insurable interest in the lives of covered rank-and-file employees at the time the policies were issued. The IRS argues that the lack of an insurable interest renders the policies void as against public policy, that the policy loans are not genuine indebtedness and, therefore, that the interest deductions are not allowable. In *Xcel Energy, Inc. v. United States*, No. 04-1449 (D. Minn. 2005), the District Court rejected the government's motion for summary judgment regarding lack of insurable interest and held that Xcel Energy in fact had an insurable interest because it had a "reasonable right to expect some pecuniary advantage from a continuance of the life of [its employees], or to fear the loss from [their] death." The court's conclusion seems to have been based on a finding that the COLI program was set up to fund death benefits provided under a pre-existing employee benefit plan and the selection of the insured lives was designed to correlate to the Xcel Energy's obligations under the plan. Concluding under Colorado law that an insured has an ability to designate a beneficiary without regard to whether the beneficiary has a financial interest in the life of the insured, the court's decision also seems to have been based on the fact that Xcel Energy had received written consent from each covered employee. The court declined to apply the decisions of two recent, non-tax, cases that found the employers to not have had insurable interests in COLI. *Mayo v. Hartfold Ins. Co.*, 354 F.3d 400 (5th Cir. 2004); *Tillman v. Camelot Music, Inc.*, 408 F.3d 1300 (10th Cir. 2005). Although the government had argued that those decisions be applied in Xcel Energy's case, the court said that it was inappropriate to impose other jurisdictions' decisions on Colorado and noted that those decisions were guided by specific provisions of the applicable state (not Colorado) insurable interest law, which made the cases legally distinguishable.

It is unclear why the IRS believes that a finding that the employer lacked an insurable interest will negate an interest deduction on any policy loan. PLR 200528023 (July 15, 2005), appears to recognize that, under state law, the lack of an insurable interest on the part of the employer does not make the life insurance contract void; it states that "the life insurance proceeds received by [the employer] . . . upon the deaths of the covered employees clearly were proceeds paid by reason death." Thus, lack of insurable interest does not seem to render the policy void. Furthermore, even if there were no insurance contract, it does not necessarily follow that the loan is an economic sham. That would depend to some extent upon whether there is a realistic expectation of repayment. In addition, if the IRS is correct that there is no insurance, but nevertheless there still is a bona fide loan, one might question whether the restrictions on deductions for policy loan interest in I.R.C. § 264 even apply.

Although the government lost its bid for a summary judgment based on the insurable interest argument in Xcel Energy, as of now the case is proceeding to trial to determine whether either the COLI program as a whole or the policy loans and interest deductions separately are economic shams.

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Sixth Circuit Overturns Taxpayer-Favorable Decision in Dow Chemical COLI Case

by Frederic J. (Rick) Gelfond

In late January, the Sixth Circuit, in *Dow Chemical v. United States*, rendered the fourth appellate level decision in an economic substance case involving the deductibility of interest associated with a broad-based purchase of life insurance by a corporation [COLI]. Despite the fact that Dow was the first taxpayer to achieve a victory at the district-court level, it fared

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no better than the previous taxpayer-litigants on this issue, as a split panel overturned the lower court in a 2-to-1 majority decision.

Given the history of success by the government on this issue, significant attention has been paid as to whether the Dow case might be reversed on appeal; regardless of the differences in facts between Dow and the earlier cases. What is curious about the decision, however, is the manner in which the court went about rendering its decision. First, the Sixth Circuit appears to have looked past its own precedent for opining on the economic substance of a broad-based, leveraged COLI transaction, as articulated in its decision in AEP. Second, it appears to have disregarded the standard of review it was required to apply in analyzing specific factual findings of the lower court.

The Determining Factors

In analyzing the lower court's decision, the Sixth Circuit examined what it identified as three "indicators" of a lack of economic substance; namely, (1) whether the insurance arrangement involved positive pre-interest deduction cash flows; (2) whether the taxpayer would benefit from "inside build-up" of cash values in the COLI contracts; and (3) whether the transaction was mortality neutral [i.e., government parlance for elimination of risk transfer].

In AEP, the Sixth Circuit focused almost exclusively on the last of these indicators; whether a sufficient amount of risk was transferred to the insurance company. In other words, whether there was such a high degree of "experience rating" that the program was mortality neutral. In an economic substance case involving insurance, that was, arguably, the correct approach. That is, it is the transfer of risk that creates the possibility of non-tax economic effects in an insurance arrangement; and hence, imbues the transaction with economic substance.

Although the typical policyholder hopes that it will not suffer the insured-against loss, it nevertheless retains the possibility of an economic profit, or positive cash flows, if or when such event should occur; for example, if an insured under a life insurance contract dies earlier than expected. As such, given the nature of insurance, if there has been a transfer of risk, a policyholder retains a possibility of an economic profit; but it cannot be held to a standard that requires an expectation of economic profit.

In a broad-based COLI situation, the realization of economic profits, if any, will depend upon when the covered individuals die. In such instance, the only expectation, although not a certainty, is that profits, or positive cash flows, if any, on the program as a whole,

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will begin to emerge as the population of covered individuals begins to age. Those profits will emerge sooner in the event the covered individuals die earlier than expected; or not at all, if the covered individuals live significantly longer than expected.

This principle holds true regardless of whether the transaction is examined on a pre- or post-tax basis, and irrespective of whether the premiums are paid through debt or equity financing.

In contrast, in Dow, the Sixth Circuit initially focused on illustrations that showed that the taxpayer might never achieve positive pre-tax deduction cash flows absent a contingent payment of cash scheduled to be made around the eighteenth policy year. Despite its near exclusive focus on the issue of risk transfer in AEP, the court does not explain its shift in emphasis in Dow to the issue of whether there was a possibility of positive pre-tax deduction cash flows.

The Standard of Review

In addition, establishing the standard it would apply in reviewing this case, the Sixth Circuit indicated that it was required to apply a *de novo* standard of review for purposes of determining the overall characterization of the transaction. It also acknowledged, however, that the specific factual findings of the lower court were subject to a clearly erroneous standard of review. Nevertheless, the court failed to apply the latter standard when examining the lower court's factual findings.

For example, even if one were to accept the notion that positive pre-tax deduction cash flows are a reliable indicator of economic substance in an insurance transaction, the lower court found, as a matter of fact, that the Dow program did involve positive pre-tax deduction cash flows. The Sixth Circuit, however, disregarded this finding, suggesting that it was dependent on the above mentioned infusion of cash by the taxpayer around the eighteenth policy year.

The court did not suggest that this factual finding of the lower court was "clearly erroneous," a fairly high

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standard to meet. Rather, it stated that the contingent future infusion of cash was irrelevant as a matter of law. Based on a strained reading of Knetsch, in which the Supreme Court found that the taxpayer in that case did not intend to make a contingent future payment, the Sixth Circuit created the following new standard:

> Courts may consider future profits contingent on some future taxpayer action, but only when that action is consistent with the taxpayer's actual past conduct.

In creating this standard, the majority avoided having to challenge the factual finding of the lower court. As noted by the dissent, however:

> [T]here is no such precedential rule of law and no warrant for creating one in this case.
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> [M]y colleagues read into Knetsch far more than the Supreme Court wrote in that case concerning the Court's refusal to accept the taxpayer's argument [regarding a potential future loan payoff].
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> . . .
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> The Court did not hold that, as a matter of law, a feasible projected future investment of cash in a particular plan is irrelevant to the economic substance inquiry, when that investment is greater than the past investment in that plan. The question is what the taxpayer intended.

In Dow, the lower court found that the taxpayer intended to make the future contingent payment. The majority, however, did not take on the question of whether this factual finding was clearly erroneous.

Similarly, the district court concluded that Dow's COLI plans had features that were designed to reduce, but not eliminate, the mortality risk transferred to the insurers. In doing so, it distinguished the Dow facts from the previously litigated broad-based, leveraged COLI cases noted above that it found involved features that resulted in a 100-percent elimination of mortality risk transfer.

The Sixth Circuit found, however, that the lower court's 100-percent standard was too high a hurdle to set as a prerequisite to finding that Dow's plans were designed to neutralize mortality gains. It then stated that the features of the Dow plans are sufficiently similar to the other COLI-plan cases for it to conclude that Dow would not significantly benefit from mortality gains; i.e., there was insufficient transfer of mortality risk.

Even if the plans in the other COLI cases did not meet the 100-percent standard—and the Sixth Circuit contended they did not—the lower court nevertheless found, as a matter of fact, that the Dow program did involve a sufficient amount of risk transfer. The Sixth Circuit, however, once again does not refer to any evidence that suggests that this finding is clearly erroneous; the requisite standard for overturning a factual finding. Moreover, while it states that none of the other COLI programs met the 100-percent risk-elimination standard, the Sixth Circuit does not provide any indication as to where it drew the line in determining whether the transaction involved a sufficient amount of mortality risk transfer.

Conclusion

While some may continue to debate the merits of the court's decision, or the manner in which it was decided, the practical reality is that most taxpayers that were involved in transactions similar to those that were the subject of the recent litigated COLI cases, have settled their matters with the government. Nevertheless, the proper manner in which to decide upon the economic substance of an insurance arrangement is a question that does not appear as though it is going to disappear from the public eye any time soon. Each of the above cases involved contracts that were issued subsequent to June 20, 1986, the effective date of legislation that affected the manner in which those transactions were structured.

The Internal Revenue Service, however, has now begun to challenge several taxpayers on their interest deductions relating to contracts issued on or before that date. In fact, the first case involving these "pre-1986" COLI arrangement is expected to go to court early next year. Given the fact that Congress has preserved the deductibility of interest on debt related to pre-1986 contracts, not to mention the significant differences between the pre-1986 cases that are currently under scrutiny and the post-1986 arrangements that have been litigated, it will be interesting to see how, if at all, the standards established by the courts in analyzing the post-1986 cases affect the manner in which the pre-1986 cases might be resolved. ◂