INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.:

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Taxpayer =

Sub =
Insurer =
Regulator =
Administrator A =
Administrator B =
Actuary A =
Actuary B =
Analyst =
P1 =
P2 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =

Year 8	=
Year 9	=
Year 10	=
Year 11	=
Year 12	=
Year 13	=
Year 14	=
Year 15	=
Year 72	=
Month A	=
Month B	=
Month C	=
Month D	=
Month E	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
Date 7	=
Date 8	=
Date 9	=
Date 10	=
Date 11	=
Date 12	=
Date 13	=
State A	=
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State C	=
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Number D	=
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Number G	=
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$aa	=
$bb	=
$cc	=
$dd	=
$ee	=
$ff	=
$gg	=
$hh	=
$jj	=
$kk	=
a%	=
b%	=
c%	=
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g%	=
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j%	=
k%	=
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q%	=
r%	=
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t%	=
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w%	=

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ISSUES:

1. Whether Taxpayer's two broad-based corporate-owned life insurance ("COLI") programs, plans P1 and P2, were shams in substance, thereby precluding Taxpayer from claiming deductions under I.R.C. § 163 with respect to interest expenses incurred on policy loans.[1]

2. Whether Taxpayer paid four of the first seven years' annual premiums for its COLI policies by a means other than indebtedness, thereby satisfying the "four-out-of-seven" safe harbor set forth at former § 264(c)(1) and the accompanying regulations.[2]

CONCLUSIONS:

1. Taxpayer purchased its COLI programs pursuant to a plan that lacked objective economic substance and lacked subjective business purpose. We conclude that Taxpayer's broad-based P1 and P2 plans were shams in substance. Therefore, Taxpayer is not permitted to claim interest deductions pursuant to § 163 with respect to interest incurred on the COLI policy loans during the years in issue.

2. Taxpayer satisfied the four-out-of-seven safe harbor set forth at § 264(c)(1). Although Taxpayer received refunds of premiums with respect to the P2 plan policies, this did not result in a "substantial increase" in premiums that requires the seven-year testing period to begin anew. Moreover, Taxpayer's receipt of certain experience-based premium refunds with respect to the second through fourth years of the P2 plan policies did not cause borrowing in those years to exceed premiums for purposes of Treas. Reg. § 1.264-4(d)(1)(ii), since that provision generally requires that premiums be determined without regard to such experience-based refunds. Thus, no portion of Taxpayer's borrowing in the second through fourth policy years can be allocated to the first policy year. Lastly, the retroactive attachment of the fixed interest rate rider to the P1 plan policies did not change the terms of the policies to a degree sufficient to require a new 7-year testing period for those policies. Although we conclude that Taxpayer has satisfied the four-out-of-seven safe harbor, Taxpayer may not

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986 and the accompanying regulations, as amended and in effect during the taxable years at issue.

[2] In 1997, Congress redesignated former § 264(c)(1) as § 264(d)(1). See Pub. L. No. 105-34, § 1084(a)(2), 111 Stat. 788, 951 (1997). Since the first seven policy years of the P1 and P2 policies occurred prior to 1997, we refer to the four-out-of-seven test in former § 264(c)(1).

deduct interest on policy loans because the P1 and P2 plans as a whole were shams in substance for purposes of § 163.

FACTS:

The taxable years in issue are Years 11 through 15. During those years, Taxpayer's predecessor company was a public utility organized under the laws of State A and regulated by Regulator, which regulated public utilities in State A.[3] This case arises out of Taxpayer's participation in a highly leveraged broad-based COLI program, wherein Taxpayer purchased life insurance policies on the lives of Number A of its employees. Taxpayer purchased the policies as part of two separate plans: (1) the P1 plan, which Taxpayer purchased in Month A, Year 2, comprised of Number B policies; and (2) the P2 plan, which Taxpayer purchased in Month B, Year 3, comprised of Number C policies. Taxpayer was the beneficiary of these life insurance policies.

Background of Life Insurance

Due to the complexity of the P1 and P2 plans, we shall first explain the basic principles of life insurance before discussing the specific facts in this case. There are two types of life insurance policies: (1) term insurance policies, which provide a death benefit for a specified term of years; and (2) whole life insurance policies, which provide a death benefit throughout the life of the insured. Insurers determine the premium charged for term insurance policies on the basis of the actuarially-calculated cost of providing the specified death benefit during the term of the policy. This cost, which varies on the basis of the insured's age and the size of the death benefit, is referred to in the insurance industry as the cost of insurance ("COI"). Insurers determine the premium charged for whole life insurance policies on the basis of the actuarially-calculated cost of providing death benefits throughout the insured's life. Thus, the premiums charged for a whole life insurance policy during earlier policy years typically involve a prefunding of COI charges for later policy years. Due to this prefunding of future mortality costs, the policyholder of a whole life insurance policy may accumulate and invest a portion of its premium payments in an account referred to as the policy's "cash value."[4] In contrast, term life insurance policies typically have no cash values. See generally Kenneth Black, Jr. and Harold D. Skipper, Jr., Life Insurance 82-83, 98-99 (Prentice Hall 12th ed. 1994).

The insurance company will increase accumulated cash value by crediting to the policyholder amounts in the nature of interest; in this sense, the policyholder's cash

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[3] For convenience, we refer to both Taxpayer and its predecessor company as "Taxpayer."

[4] The premiums for both term and whole life policies also include, in addition to COI charges, amounts to pay for the insurer's administrative costs and to provide the insurer with a profit.

value is similar to an interest-bearing bank account. The source of these additional credits is the income generated by the insurance company's investments. This additional contribution to the policyholder's cash value is referred to as "inside buildup."

The owner of a whole life policy may use loans or withdrawals to access the policy's cash value during the insured's lifetime. Policy loans are typically structured as a loan from the insurance company to the policyholder, with the policy's cash value serving as collateral for the loan. The loan is deemed to have been made from the general assets of the insurance company, not as a withdrawal from the accumulated cash value of the policy. If the insured dies before the loan is repaid, the amount of the loan and accrued loan interest is deducted from the death benefit payable under the policy. Policy withdrawals, whereby the policyholder withdraws a portion of the cash value, may similarly reduce the death benefit; however, in contrast to policy loans, the policyholder has no obligation to repay amounts withdrawn.

There are two primary tax benefits arising from the ownership of life insurance policies: (1) taxpayers may defer tax on their policy's inside buildup; and (2) taxpayers may exclude from income any death benefits received pursuant to § 101(a). In addition, policyholders may in certain instances deduct interest incurred on policy loans. This combination of deferral of taxation of inside buildup, the exemption of taxation of death benefits, and the deductibility of interest on policy loans has historically created the opportunity for tax arbitrage by policyholders. By using an asset that produces tax-deferred income as security for a loan, a taxpayer is able to deduct interest incurred on the loan while the secured asset increases in value tax free.

With these concerns in mind, Congress in 1964 enacted limitations on the deductibility of policy loan interest. Particularly, Congress amended § 264 to provide that no deduction is allowed for amounts paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance contract pursuant to a plan of purchase which contemplates the systematic borrowing of part or all of the increases in the cash value of such contract. § 264(a)(3) (1964). Congress also enacted an exception to this general disallowance rule with respect to interest paid or accrued on policy loans incurred or continued as part of a plan whereby no part of 4 of the first 7 annual premiums due on the contract is paid by means of indebtedness. § 264(c)(1) (1964). This safe harbor is commonly referred to as the "four-out-of-seven" safe harbor. Legislative history reflects that Congress enacted these provisions with a concern that some insurance companies were marketing insurance policies to individuals primarily as tax-saving devices. S. Rep No. 88-830 (1964), reprinted in 1964-1 C.B. (Part 2) 505, 581-582. Congress also explained that it fashioned the four-out-of-seven safe harbor, in part, to preserve the value of life insurance generally by retaining some rights in the individual to borrow on insurance, as one could in the case of other assets. Id. at 583.

Congress' efforts in 1964 did not end the use of tax arbitrage associated with life insurance. Corporations began purchasing COLI on the lives of their employees as a means of generating large policy loans, interest deductions, and tax savings. Congress in 1986 attempted to address this perceived abuse by eliminating the interest deduction on policy loans to the extent that the aggregate indebtedness exceeds $50,000 per employee, effective June 20, 1986. § 264(a)(4) (1986).[5] The Joint Committee on Taxation Staff, in explaining reason for this provision, stated: "Congress did not intend to allow these loans to be an unlimited tax shelter as under prior law." See Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 579 (Comm. Print 1987).

In an attempt to circumvent the $50,000 per policy limitation, insurance industry specialists marketed "broad-based" COLI programs in which a corporation purchases insurance on thousands of its non-executive employees, regardless of the value of the employees' services to the corporation.[6] Thus, by increasing the number of policies issued in the COLI plan, the corporation could increase aggregate policy loans and loan interest deductions while remaining within the $50,000 per policy loan limit. In 1996, Congress, believing that these broad-based COLI programs were inappropriate, once again amended § 264 by entirely eliminating the availability of policy loan interest deductions generated by COLI programs, except for certain key person insurance programs. § 264(a)(4), (d) (1996). The Joint Committee on Taxation, in explaining the purpose of the legislation, particularly noted Congress' concern for transactions in which taxpayers borrow against the value of their policies at an interest rate only slightly higher than the interest rate at which the insurer credits inside buildup to the policies. See Staff of Joint Comm. on Taxation, 104th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in the 104th Congress 363-364 (Comm. Print 1996). The Joint Committee also explained that Congress, in amending § 264, did not intend that taxpayers make inferences concerning the deductibility of policy loan interest paid or incurred prior to the effective date of the 1996 legislation. Id. at 367.

Taxpayer's COLI Transactions

Taxpayer, when it began considering the P1 and P2 plans, provided life insurance benefits to its retired employees in the amount of % of a retired employee's salary as of the date of retirement.[7] Taxpayer paid for these benefits as part of a "pay-as-you-

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[5] In 1986, Congress also enacted § 163(h) (1986), which disallows deductions for personal interest. Consequently, life insurance tax arbitrage plans were no longer marketed to individual taxpayers after the effective date of this legislation, since individuals could no longer deduct interest incurred on policy loans.

[6] We note that Taxpayer purchased the P1 and P2 plans prior to the June 20, 1986, effective date of the $50,000 per policy limitation. Nevertheless, given the number of policies that Taxpayer purchased, we consider Taxpayer's COLI programs to be broad-based.

[7] Taxpayer also provided death benefits to employees who died prior to retirement.

go" program administered by Administrator A, and recovered the cost of the benefits from its customers through the rates set by Regulator.[8] In Year 1, a life insurance broker ("Broker") who was developing Taxpayer's executive compensation plans advised Taxpayer that Taxpayer faced a large unfunded liability attributable to the life insurance benefits provided to its retired employees. In Year 1, Broker estimated the liability at approximately $a; by the following year, Broker's estimate had grown to $b.[9] Broker recommended that Taxpayer fund the liability by purchasing COLI on the lives of some of its employees, naming Taxpayer as the beneficiary. Taxpayer rejected Broker's proposal due to concerns over the proposal's regulatory treatment and financial feasibility.

During Year 2, Broker attempted to reduce Taxpayer's post-retirement life insurance liability by advising Taxpayer to create a new benefits program whereby Taxpayer's employees aged   years or older would retain eligibility for post-retirement life insurance benefits, but employees younger than age   would not be eligible for such benefits. Broker further recommended that Taxpayer switch the plan administrator from Administrator A to Administrator B, but continue to pay for the program on a pay-as-you-go basis. Broker's goal was to address both Taxpayer's liability and Taxpayer's concerns regarding Administrator A's expenses and customer service problems. In conjunction with these proposals, Broker also offered to Taxpayer a new COLI plan whereby Taxpayer would purchase whole life insurance on its employees aged   years or older. Broker suggested that the cost of the COLI plan be paid by Taxpayer's shareholders, rather than through Taxpayer's rate base.

Broker requested Actuary A, an actuarial consulting firm, to review Broker's proposal to Taxpayer. By letter to Broker dated Date 1, Year 2, Actuary A explains that the purposes of the proposed COLI plan were to fund: (1) one-half of the death benefits payable to active employees aged   and over; (2) all of the post-retirement death benefits for current employees aged   or older; and (3) all of the death benefits for existing retirees, who were nonetheless not lives actually insured under the proposed policies. An appendix attached to the letter contains four individual policy illustrations that describe a plan whereby Taxpayer pays four out of the first seven annual premiums in cash, pays the remaining three premiums through policy loans, borrows heavily from the policies' cash value in each policy year after the seventh, and deducts policy loan interest for Federal income tax purposes at a bracket of 49%. Actuary A concludes that Broker's proposal, "when viewed as an investment," produces a net after-tax rate of return to Taxpayer over the life of the policies in the amount of a%.

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[8] Taxpayer refers to these pay-as-you-go programs as "cost plus" plans, whereby Taxpayer pays the administrator for the cost of accrued death benefits, plus administrative expenses.

[9] This liability fluctuated on the basis of the number of eligible employees and wage inflation.

Specifically, Actuary A explains: "The large write-off of the life insurance program has created a tax savings which substantially reduces the cost of the [employee benefits] program."

Taxpayer initially agreed with Broker's advice, switching its benefit plan administrator to Administrator B, and purchasing a COLI plan, which it identified as "P1," in Month A, Year 2.[10] Taxpayer, however, did not implement Broker's advice to stop providing post-retirement life insurance benefits for employees aged younger than years. The P1 plan was comprised of Number B policies insuring employees aged years or older, had a total face value of $c, and an annual premium of $d. The policies were written by Insurer, a company with a home office in State B. The P1 policies were held by a State B Multiple Employer Trust, and Taxpayer was issued trust certificates representing Taxpayer's ownership interest in the policies.

Broker in Month C, Year 3, proposed that Taxpayer purchase from Insurer an additional COLI plan beyond the P1 plan coverage that Taxpayer purchased in Month A, Year 2. Broker prepared a written proposal, dated Date 2, Year 3, with a supplement dated Date 3, Year 3, in an attempt to convince Taxpayer to purchase the additional insurance. The proposal explains that, prior to purchasing the P1 plan, Taxpayer had decided to reduce its potential post-retirement death benefit liabilities by implementing a "new" post-retirement benefits program, into which all existing employees could opt. Particularly, the proposal notes that, prior to purchasing the P1 plan, Taxpayer had initially agreed with Broker's advice to limit eligibility in the existing benefits program to employees aged and over, but eventually decided to allow all existing employees the opportunity to remain in the existing plan due to "moral or perhaps legal age discrimination" concerns.

With respect to Taxpayer's purchase of an additional COLI plan, Broker's proposal specifically sets forth: (1) an estimate of Taxpayer's liability for post-retirement death benefits, based on various assumptions regarding the rate of salary increase, attrition, and the number of employees electing to forgo post-retirement benefits to join Taxpayer's new post-retirement benefit program;[11] (2) a proposed COLI plan in which Taxpayer will purchase an additional Number D policies with an initial face amount of $e each, whereby Taxpayer will pay premiums in the first, fifth, sixth, and seventh policy years, borrow heavily from the policy cash values to pay premiums for the second, third,

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[10] Taxpayer is unable to locate the original policy illustrations underlying the P1 plan.

[11] Broker's projected liability is between $f and $g, with an anticipated liability of $h.

fourth, and eighth policy years, and all policy years thereafter;[12] (3) anticipated cash flows from the proposed COLI plan projected over 30 years and expressed in terms of "after-tax outlays," rather than in terms of death benefits receivable;[13] and (4) an internal rate of return analysis of various COLI products offered by different companies. Broker's proposal does not indicate that the anticipated death benefits payable from the COLI policies would be fashioned to correspond with Taxpayer's liability to pay death benefits to its retired employees.

Regarding the timing of Taxpayer's proposed purchase of the new COLI plan, Broker's proposal also recommends that "[i]t would be ideal to wait until the fall of [Year 4] to exactly measure the liability and increase the reinsurance funding at that time; however, imminent tax law changes are anticipated." In this vein, Broker's proposal explains that Insurer will allow cancellation of the new COLI plan, less commissions and "pure mortality charges," if tax laws are enacted that adversely affect the designed operation of the plan. On Date 4, Year 3, Insurer's Senior Vice President sent to Taxpayer a "honeymoon letter" regarding pending tax legislation affecting COLI. The letter states:

> This is to assure you that in the event legislation affecting policyholder taxation is enacted and is effective prior to [Date 5, Year 4] which in the opinion of [Taxpayer] is substantially adverse, we will do all in our power to provide an alternate funding vehicle for you. . . . If it remains impossible to amend the policy or provide an alternate funding vehicle . . . [Insurer] will allow immediate cancellation. . . . [P]remiums will be refunded at that time [to the extent that premiums] are in excess of the term cost of providing protection from the effective date of the policies to the date of cancellation. . . .

Soon after receiving Broker's proposal, Taxpayer purchased an additional COLI plan, identified as "P2," which was comprised of Number C policies insuring Taxpayer's employees between the ages of and .[14] The policies were written by Insurer, and had an initial total face value of $m and annual premiums of $n. In similar fashion to the P1 policies, the P2 policies were held by a State B Multiple Employer Trust, and Taxpayer was issued trust certificates representing Taxpayer's ownership interest in the

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[12] Taxpayer purchased nearly four times more than the number of policies recommended in the proposal.

[13] Broker's 30-year projected after-tax cash flow is between $j and $k, depending upon Taxpayer's desired "funding level" for the proposed plan. Broker's low-end estimate of after-tax cash flow is more than two times greater than $g, Broker's high-end estimate of Taxpayer's post-retirement death benefit liability.

[14] Taxpayer is unable to locate the original policy illustrations underlying the P2 plan.

policies. Even after purchasing the P1 and P2 plans, Taxpayer maintained the pay-as-you-go program administered by Administrator B.

Features of the P1 and P2 Policies

The P1 and P2 policies were whole life policies with level premiums until age 100 and an initial face amount of $e for each life. The death benefits payable under the P1 and P2 policies increased annually; however, the annual death benefit for the P2 policies increased by approximately b%, while the annual death benefit for the P1 policies increased by approximately c%. Moreover, the annual death benefit increases for the P2 policies continued to the end of the contract, whereas the death benefit increases for the P1 policies continued only until age .

The COI under the P1 and P2 policies was determined on the basis of the age of each participant, the monthly cost of insurance rates per $1,000 of coverage, and the guaranteed death benefit factor set forth on each policy's data page. In addition to the COI charges, Insurer imposed several other charges, including: (1) a front-loaded expense charge imposed only during the first ten policy years, based on the participant's age at the inception of the policy, with an initial charge imposed during the first policy year and a lower charge imposed during policy years two through ten;[15] (2) a percentage expense charge, which was a contractually-fixed percentage of the annual premium as stipulated on the data page of each policy;[16] and (3) a flat fee for each policy in force at the beginning of the policy year in the amount of $r for each P1 policy and $s for each P2 policy.

The P2 plan also contained provisions whereby Taxpayer could receive premium refunds on the basis of the following: (1) a first year policy volume discount equaling k% of gross premiums payable for that year; (2) a "guaranteed mortality profit contribution" refund payable for the first five policy years; and (3) a "fluctuation reserve contingency payment" in effect throughout the term of the policies. The k% volume premium discount reduced the premiums payable for the first policy year from $t to $u. The other two refund provisions were based on the actual claims experience of the P2 policies. The guaranteed mortality profits contribution was equal to m% of the difference

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[15] For example, a policy covering -year old participant in the P2 plan was subject to a $p monthly expense charge in the first policy year, and a $q monthly expense charge for policy years two through ten.

[16] The percentage expense charge for the P1 policies ranged from d% to e%, based on the policy year and age of the participant. The percentage expense charge for the P2 policies were solely determined on the basis of policy year, as follows: f% for policy year one; g% for policy years two through five; h% for policy years six through ten; and j% for each year thereafter.

between the cost of insurance and death benefits paid.[17] The fluctuation reserve contingency payment, although involving an elaborate calculation, was similarly designed to refund to Taxpayer a portion of the excess of actual claims paid over the cost of insurance, particularly after the fifth policy year.

Since the P1 and P2 policies were whole life insurance policies, Taxpayer was eligible to obtain policy loans from Insurer, and Insurer credited the policies' cash value with inside buildup. The policies provided for three relevant interest rates: (1) the interest rate that Taxpayer paid on policy loans; (2) the "loaned crediting rate," which was the rate at which Insurer would credit the portion of the policies' cash value that was used to secure policy loans; and (3) the "unborrowed crediting rate," which was the rate at which Insurer would credit the portion of the policies' cash value that was not used to secure policy loans. Taxpayer could borrow up to n% of the cash value from the P1 policies, and p% of the cash value from the P2 policies; thus, the principal and interest accrued and unpaid on policy loans could not exceed the policies' cash value. Taxpayer could repay policy loans at any time, but the loans did not have to be repaid until the death of the insured party.

Under the provisions of the policies, Taxpayer was eligible to choose annually from one of two policy loan interest rate options: a "variable" option, and a "fixed" option. Under the variable option, Taxpayer would pay an interest rate on policy loans determined by the "Moody's Corporate Bond Yield Average," published by Moody's Investors Service, Inc., as of two months before the plan anniversary. If the Moody's rate had not fluctuated more than Number F basis points during the policy year, then the prior year's rate would apply.[18] If Taxpayer chose the variable option, Insurer guaranteed that the loaned crediting rate would be equal to Number G basis points less than the policy loan rate for P1 policies, and Number H basis points less than the policy loan rate for P2 policies.[19] Accordingly, regardless of the interest rate applicable to policy loans under the variable option, Taxpayer's actual cost of borrowing remained constant because there was a pre-determined "spread" between the loan interest rate and the loaned crediting rate. Under the fixed option, Taxpayer could elect to pay interest on policy loans at a rate equal to the Moody's Corporate Bond Yield Average rate in effect two month prior to the policies' issue date, but the loaned crediting rate was "declared" by

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[17] Thus, if the cost of insurance charges were $100, and the death benefits payable was $90, the refund to Taxpayer under the mortality profit contribution provision was m% of $10.

[18] A basis point is equal to one hundredth of one percent.

[19] The policy forms provided that "if any part of the Total Cash Value is subject to a loan, the interest rate applicable for that part of the Total Cash Value shall be at a rate which is [Number G basis points for the P1 plan and Number H basis points for the P2 plan] less than the loan interest rate in effect."

Insurer and not expressly guaranteed.[20] The fixed option was attached as a rider to the P2 policies when those policies were issued, and was retroactively attached to the P1 policies at the same time.

Approximately four months after Taxpayer purchased the P2 policies, Broker sent a letter to Taxpayer, dated Date 6, Year 3, which explains the tax and regulatory motivations underlying the fixed and variable interest rate options. In relevant part, the letter provides:

> An insurance company can only guarantee in the policy the actuarial rates that are used to generate the values of the policy. An obvious problem arises when a variable loan interest rate policy is used.
>
> * * * * *
>
> Another constraint is an income-tax issue. . . .
>
> * * * * *
>
> If, for example, the Moody's rate at policy issue was 12% and the current rate was 10%, how can a taxpayer justify paying the high rate? The Internal Revenue Service easily could disallow the deduction as simply being for tax purpose [sic] only. Why else would you pay more interest than you had to?
>
> The solution to these issues is an annual option that [Taxpayer] will have.
>
> > Option A [Variable Rate Option]
> > – Loan interest rate determined by Moody's
> > – Spread on [P1] [Number G] basis points
> > – Spread on [P2] [Number H] basis points
> >
> > OR
> >
> > Option B [Fixed Rate Option]
> > – Loan interest rate equal to rate in effect at issue
> > – Spread not a guaranteed rate, but rather a declared rate

[20] Specifically, the policy forms for the fixed rate rider provided that "if any part of the Total Cash Value is subject to a loan, the interest rate credited on that part of the Total Cash Value shall be an effective rate of interest of [q% for the P1 plan and c% for the P2 plan] or any higher rate set by us."

> This solution solves [Insurer's] dilemma because they are not guaranteeing rates in excess of model law constraints.[21]
>
> This solution solves [Taxpayer's] potential tax issues because you can justify paying the higher loan interest because at the time of your decision you did not have a guarantee of what rate would be credited. There was a risk element to justify your higher interest expense.
>
> If interest rates rise above the levels at issue, the contractual provision will apply (Option A), and Option B won't be necessary.

Although the fixed interest rate option did not expressly guarantee a specific loaned crediting rate due to state regulatory concerns, Taxpayer and Insurer understood that if Taxpayer elected the fixed rate option, Insurer would use a loaned crediting rate that produced the identical pre-determined spread that was expressly available under the variable interest rate option, i.e., Number G basis points for the P1 policies and Number H basis points for the P2 policies. Concerning the manner in which Insurer intended to exercise its discretion to declare a loaned crediting rate if Taxpayer elected the fixed interest rate option, Broker's Date 6, Year 3 letter further explains:

> [T]he bottom line of all of this is the arbitrage could be reduced if [Insurer] chose to treat [Taxpayer] badly. This is extremely unlikely . . . . They could only treat [Taxpayer] badly once and on subsequent anniversary [Taxpayer] could choose Option A or drop the policy.

Therefore, the purpose of the fixed rate rider was to create a floor, rather than a ceiling, on the rate of interest that Taxpayer paid on policy loans. Since Taxpayer's actual cost of borrowing was reflected in the pre-determined spread between the policy loan interest rate and the loaned crediting rate, Taxpayer had no economic incentive to

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[21] It appears that the "model law constraints" that Broker refers to are those set forth by the National Association of Insurance Commissioners ("NAIC") Model Policy Loan Interest Rate Bill, which the NAIC first adopted in 1981. See 1981 Proceedings of the National Association of Insurance Commissioners, I, pp. 47, 51, 421, 517, 534, 535-536. Section 3(B) of the model bill limits the interest rate charged on policy loans to the higher of: (1) Moody's Corporate Bond Yield Average for the calendar year ending two months before the date on which the policy loan interest rate is determined; or (2) the rate used to compute cash surrender values under the policy during the applicable period plus one percent per annum. State B adopted these model bill provisions prior to the issuance of the P1 and P2 policies. See State B Code § Number E (imposing policy loan interest rate limitations effective [prior to Year 2]). Insurer, by annually declaring the loaned crediting rate under the fixed rate option, ensured that Taxpayer could incur a policy loan interest rate that exceeded the Moody's Average rate then in effect without violating the model bill.

reduce the rate of interest imposed on policy loans. To the contrary, Taxpayer generated more policy loan interest deductions by paying a higher rate. If interest rates decreased after the policies were issued, Taxpayer could elect the fixed rate option, thereby generating higher policy loan interest deductions than would be available under the variable option. Given the interest rates in effect when the policies were issued, the fixed rate option ensured the Taxpayer would pay interest on P1 policy loans at no lower than r%, and on P2 policy loans at no lower than s%.

Taxpayer's Administration of the P1 and P2 Policies

The following tables summarize Taxpayer's actual cash flow resulting from the P1 and P2 plans, from their inception through the taxable years at issue:

P1 Plan (dollars in thousands)

Policy Year Ending	Premiums (A)	Policy Loans (B)	Loan Interest (C)	Net Death Benefits (D)	Pre-Tax Cash Flow (B+D-A-C)	Tax Savings (E)	Net After-Tax Cash Flow (B+D+E-A-C)

P2 Plan (dollars in thousands)

Policy Year Ending	Premiums (A)	Policy Loans (B)	Loan Interest (C)	Net Death Benefits (D)	Pre-Tax Cash Flow (B+D-A-C)	Tax Savings (E)	Net After-Tax Cash Flow (B+D+E-A-C)

The tables reflect that, consistent with Actuary A's illustrations concerning the P1 plan and Broker's proposal concerning the P2 plan, and in an effort to comply with the "four-out-of-seven" safe harbor set forth in § 264, both the P1 and P2 plans were structured so that Taxpayer would pay out-of-pocket for premiums in the first, fifth, sixth, and seventh policy years, and borrow from policy cash values to pay premiums for the second, third, fourth policy years. The plans were further designed so that Taxpayer could borrow against most of the policies' remaining cash values in the eighth policy year and all policy years thereafter. As of Date 11, Year 15, Taxpayer's total net equity in the P1 and P2 policies was $v, representing t% of the total gross cash value of the policies.[22]

[22] The term "net equity" refers to a policy's cash surrender value, less any loans or interest accrued on loans secured by the policy.

As explained, the P2 plan contained provisions whereby Taxpayer could receive premium refunds in certain instances. Taxpayer received the following premium refunds during the first seven years of the P2 policies (dollars in thousands):

Policy Year Ending	Gross Premium	Volume Discount Refund	Guaranteed Mortality Refund and Fluctuation Reserve Contingency Refund	Net Premium

After purchasing the P1 and P2 plans, Taxpayer formed a subsidiary, Sub, for the purpose of holding the ownership certificates for the P1 and P2 policies. Taxpayer capitalized Sub with $w in cash, and transferred to Sub its ownership interest in the P1 and P2 policies. The $w payment was in an amount calculated to allow Sub to pay for further anticipated premiums and policy expenses through Month B, Year 9, the end of the seventh policy year for the P2 policies, after which Taxpayer anticipated that the P1 and P2 policies would pay for themselves and provide net excess cash for Taxpayer's use.

Taxpayer did not recover the initial costs of the P1 and P2 policies from its ratepayers; thus, Taxpayer's shareholders paid the up-front cost associated with the COLI plans. Moreover, Taxpayer's shareholders, not the ratepayers, paid the pay-as-you-go cost of Taxpayer's post-retirement death benefit program after Taxpayer purchased the P1 and P2 plans.[23] Taxpayer further intended that any after-tax benefits generated by the P1 and P2 plans, net of the pay-as-you-go cost of its post-retirement death benefit program, be directed solely to its shareholders.

[23] As explained infra, several years after purchasing the P1 and P2 plans, Taxpayer began recovering from its ratepayers the cost of providing post-retirement death benefits.

On Date 12, Year 4, less than a year after purchasing the P2 plan, Taxpayer implemented a new employee benefits program. Taxpayer's new program limited eligibility for post-retirement death benefits to all of its then active and retired employees. This was less restrictive than Broker's initial recommendation, which would have limited such benefits to active employees then aged or older. Nevertheless, Taxpayer's new program reduced its projected cost for providing post-retirement death benefits. Since the number of participants eligible for post-retirement benefits was fixed as of that date, wage inflation was the only factor that could increase Taxpayer's liability. Taxpayer's new program further provided its then active employees with an option that would provide an increased two-times salary pre-retirement death benefit while eliminating post-retirement death benefits. Any then active employees who exercised this option further reduced Taxpayer's liability for post-retirement benefits.

In Year 4, Broker retained Actuary B to perform an actuarial study projecting Taxpayer's post-retirement death benefit liabilities and comparing them to the projected cash flows from the P1 and P2 plans. The study, dated Month D, Year 4, indicated that Taxpayer, in implementing its new employee benefits program, reduced its potential liability for post-retirement death benefits payable to its then current or retired employees by between u% and k%. Additionally, the study calculated the after-tax cash flows expected from the P1 and P2 plans under the assumption that Taxpayer would borrow heavily from policy cash values and claim Federal income tax deductions for interest accrued on policy loans, which, in turn, would generate positive cash flow for Taxpayer by reducing its tax liability. The study sets forth two different illustrations with varying marginal federal income tax rates and present value discount factors. The study concludes that, as of the beginning of Year 4, the potential gain from the P1 and P2 plans, determined by subtracting the present value of future post-retirement death benefit liabilities from the present value of future after-tax earnings expected from the P1 and P2 plans, is as follows:

	Assuming % Marginal Tax Rate and % Discount Rate	Assuming % Marginal Tax Rate and % Discount Rate
After-Tax Present Value of P1 and P2 Plans, Including Experience Refunds		
Present Value of Post-Retirement Group Liabilities for Current and Future Retirees		
Net Present Value		

According to the actuarial study, the present after-tax value of the P1 and P2 plans as of the beginning of Year 4 was between and times greater than Taxpayer's projected liability for post-retirement death benefits. In this regard, Actuary B's study concludes:

> . . . [Taxpayer] has substantially covered its projected post-retirement liabilities with expected gains from corporate-owned life insurance. As a result, [Taxpayer] may want to utilize some of the extra gains for covering the liabilities of other post-retirement programs.

During the same month in which Actuary B prepared its actuarial study, Broker prepared a document called "[Sub] Dividend Scenarios," which explains what Taxpayer can do with the positive cash flows generated by the P1 and P2 plans, payable to Taxpayer in the form of dividends from Sub. Broker suggests that Taxpayer, in addition to using the dividends to pay for post-retirement death benefits, use the dividends for: post-retirement health care costs; executive salary continuation; dividends to Taxpayer's shareholders; deferred benefits for Taxpayer's directors; and "other" expenses.

Actuary B's study also sets forth the following -year projection of "annual after-tax expected cash flows" from the P1 and P2 policies for Years 2 through 72, assuming a % marginal tax rate and a % interest rate:

(A) Pre-tax cash flow: Loan proceeds and net death benefits received, less premiums and interest payable	(B) Tax benefit from interest deduction	(C) After-tax cash flow: (B - A)

Thus, the projections indicate that, but for the tax benefits derived from policy loan interest deductions, Taxpayer's cash flow from the P1 and P2 plans would result in a loss of ($x). The projections further indicate that, except for Years 4 and 10, the P1 and P2 plans would generate negative pre-tax cash flows for each year between Year 2 and Year 72.

Taxpayer has had policy loans outstanding on the P1 and P2 policies during each policy year after the first policy year. Taxpayer has chosen the fixed interest rate option each year, and the interest rate Taxpayer has paid on policy loans has exceeded market interest rates for most of the time that the P1 and P2 plans have been in effect. Consistent with Broker's assurance reflected in the letter dated Date 6, Year 3, Insurer declared a loaned crediting rate under the fixed rate option that produced the identical pre-determined spread between the policy loan interest rate and loaned crediting rate as was expressly available under the variable rate option, i.e., Number G basis points for the P1 policies, and Number H basis points for the P2 policies. In contrast, the unborrowed crediting rate was based on current U.S Treasury Bill rates, subject to a minimum rate. Therefore, since Taxpayer first began borrowing from the P1 and P2 policies, the unborrowed crediting rate has fluctuated on the basis of market conditions, and has always been less than the loaned crediting rate. The following chart reflects the P1 and P2 policies' annual policy loan interest rates, annual loaned crediting rates, annual unborrowed crediting rates, Moody's Corporate Average Monthly Bond Rates, and Insurer's annual portfolio earnings rates:[24]

Calendar Year in which policy year began	P1 Loan interest rate/loaned crediting rate	P2 Loan interest rate/loaned crediting rate	Unborrowed crediting rate (high/low)	Moody's Corporate Avg. Monthly Bond Rate (high/low)	Insurer's Portfolio Earnings Rate

The table reflects that, during the five taxable years in issue, Taxpayer paid interest on P1 policy loans at a rate that was between % and % greater than Moody's Corporate Average Monthly Bond Rates, and paid interest on P2 policy loans at a rate that was between % and % greater than the Moody's rate.

As noted previously, the P1 and P2 policies were initially held by a State B Multiple Employer Trust, and were subject to the laws of State B. In Year 5, however, the fixed

[24] Insurer's portfolio earnings rate represents Insurer's total net investment income divided by the average of the beginning and ending cash and invested asset portfolio balances.

option policy loan interest rate for the P1 policies exceeded the interest rate permitted under State B's usury laws.[25] Accordingly, Insurer transferred the master policies to a pre-existing Multiple Employer Trust located in State C, where there were no such restrictions on policy loan interest rates.

Taxpayer's Reporting of the P1 and P2 Transactions for Financial Accounting and Regulatory Purposes

When Taxpayer purchased the P1 and P2 plans, for purposes of its financial statements it accounted for its post-retirement death benefit liabilities on a pay-as-you-go basis, which was consistent with the manner in which Taxpayer paid Administrators A and B for those liabilities. In December 1990, however, the Financial Accounting Standards Board ("FASB") issued Statement No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions" ("FAS 106"). FAS 106, which was generally effective for fiscal years beginning after December 15, 1992, requires employers to estimate and accrue the expected cost of providing an employee's post-retirement benefits during the years in which the employee renders the necessary service. Consequently, for financial accounting purposes, Taxpayer could no longer accrue post-retirement benefits as they arose, but rather, had to accelerate the liabilities while the employees were active. FAS 106 also imposed a "transition cost" attributable to post-retirement liabilities that were deemed accumulated and accrued under FAS 106, but which had arisen in years prior to implementation of FAS 106 and had not yet been recorded as an obligation under a pay-as-you-go accounting method.

During Year 10, and after the issuance of FAS 106, Regulator approved a rate Settlement Agreement with Taxpayer that addressed the accounting and regulatory treatment of Taxpayer's liabilities for post-retirement benefits. The agreement and subsequent amended agreements permitted Taxpayer to recover the cost of its post-retirement life insurance liabilities from its ratepayers on a pay-as-you-go basis, and permitted Taxpayer to amortize and recover from its ratepayers over twenty years any transition costs resulting from the implementation of FAS 106. Accordingly, the agreement permits Taxpayer to fully recover from its ratepayers the cost of its post-retirement life insurance program. The after-tax cash flow generated by the P1 and P2 plans, although initially allocated in part towards the cost of Taxpayer's post-retirement death benefit liabilities, is no longer needed to pay for such liabilities.[26]

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[25] State B's usury rate is based on the Federal Reserve Average Prime Lending Rate, plus v%.

[26] In addition, the after-tax cash flow generated by the P1 and P2 plans continue to be directed to Taxpayer's shareholders, rather than being used to reduce the rates charged to its customers. Regulator reaffirmed this in a Year 15 rate case involving Taxpayer, in which State A's Consumer Counsel wanted Taxpayer to share Sub's tax benefits with its Taxpayer's ratepayers. Regulator agreed with Taxpayer that the

In Month E, Year 12, Taxpayer met with several representatives from bond rating agencies to discuss Taxpayer's liabilities for policy loans relating to the P1 and P2 plans. Specifically, Taxpayer was concerned about the treatment of those loans for purposes of its financial ratings. Analyst, Taxpayer's Financial Analyst who assisted Taxpayer in purchasing the P1 and P2 plans, prepared a document and provided it to the bond rating agencies. The document explains Sub's policy loan interest expense as follows:

> [Sub's] COLI has been grandfathered under the tax laws in effect before the Tax Reform Act ["TRA"] of 1986. Under pre-[TRA] rules, interest paid by corporations for loans drawn against insurance policy cash values is fully deductible. The build-up of value inside the insurance policies is tax deferred and, [sic] since the COLI is held until the death of the insured individuals, all income becomes tax exempt. [Sub's] COLI was designed to take advantage of this imbalance in tax treatment. It is most valuable when cash values are routinely borrowed by the policy owner – creating a beneficial tax arbitrage.

[emphasis added]. The document also states:

> This is very nearly a self-sustaining cycle: the loans pay the premium and most of the interest expense; and any out-of-pocket cash needed to make up the difference comes from the tax benefits derived from the interest expense . . . . The tax benefits make the difference between self-sustaining and self-liquidating. The only way in which [Taxpayer's] operations support [Sub] is indirect; [Taxpayer] must have sufficient taxable income to offset [Sub's] tax benefits. [Taxpayer's] operating income is otherwise entirely available to support [Taxpayer's] other indebtedness.

Taxpayer also made a slide presentation to the bond rating agencies on Date 13, Year 12, describing the P1 and P2 policies as "Insurance Designed to be 'Stripped'" with "Maximum Borrowing" and "Maximum Interest and Tax Benefits." The slides indicate that the policies will result in pre-tax losses to Taxpayer, discounted to present value, of ($y). The slides further indicate, however, that these losses are offset by the present value of the tax benefits, $z. Moreover, the slides describe Taxpayer's "Working Strategy" in owning the P1 and P2 policies as reducing the tax liability of Taxpayer's consolidated group, and as producing cash flows that contribute to the gradual growth of Taxpayer's core business and new related business.

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ratepayers should not share the benefits, since they did not incur the initial cost of the P1 and P2 plans.

Upon Examination of Taxpayer's returns for Years 11 through 15 (encompassing policy years ten through fourteen for the P1 policies and nine through thirteen for the P2 policies), the Field concluded that Taxpayer could not claim as deductions for income tax purposes the interest that Taxpayer incurred on loans secured by the P1 and P2 policies. The Field has set forth two reasons for the proposed disallowance: (1) the P1 and P2 plans were shams in substance for purposes of § 163; and (2) Taxpayer failed to satisfy the four-out-of-seven test set forth in § 264(c)(1).

LAW AND ANALYSIS

1. Whether the P1 and P2 plans were shams in substance, thereby precluding Taxpayer from claiming deductions under I.R.C. § 163 with respect to interest expenses incurred on policy loans.

At issue in this case is whether Taxpayer is entitled to claim deductions under § 163(a) with respect to interest incurred on loans secured by the policies that comprised the P1 and P2 plans. Section 163(a) provides: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." Court opinions, however, have established that taxpayers are not entitled to claim interest deductions under § 163 if the interest is derived from a sham transaction aimed solely at tax avoidance. See Knetsch v. United States, 364 U.S. 361 (1960); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966).

The sham transaction doctrine originated in the Supreme Court in Gregory v. Helvering, 293 U.S. 465, 469 (1935). In Gregory, the Court denied reorganization treatment with respect to a stock distribution even though the taxpayers had seemingly complied with the Code's requirements concerning reorganizations. The Court, in deciding that the distribution was taxable as a dividend, concluded that the structure of the transaction was a "mere device" for the "consummation of a preconceived plan" and not a reorganization within the intent of the Code. Id. The transaction, because it lacked economic substance, was not "the thing which the statute intended." Id.

Courts have recognized two basic types of sham transactions: shams in fact and shams in substance. Kirchman v. Commissioner, 862 F.2d 1486, 1492 (11th Cir. 1989). Shams in fact are transactions that occurred only on paper and not in reality, whereas shams in substance are transactions that actually occurred but are lacking in economic substance. See ACM Partnership v. Commissioner, 157 F.3d 231, 247 n.30 (3rd Cir. 1998). Therefore, a transaction that lacks economic substance is not recognized for Federal tax purposes and cannot give rise to a deductible expense. See United States v. Wexler, 31 F.3d 117, 122 (3d Cir. 1994).

The parties in this case do not dispute whether the P1 and P2 transactions occurred; rather, they dispute whether the transactions are shams in substance. Interest payments, in particular, are not deductible if they arise from transactions lacking “purpose, substance, or utility apart from their anticipated tax consequences." Goldstein, supra, at 740. The fact that an enforceable debt exists between the borrower and lender is not determinative of whether the debtor may deduct interest arising from that debt. See Wexler, supra, at 125. Rather, the transaction as a whole, of which the debt is a part, must have economic substance before the debtor may deduct the interest. See Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279 (1999), aff’d, 254 F.3d 1313 (11th Cir. 2001). Otherwise, every tax shelter, no matter how lacking in substance, could generate an interest expense deduction as long as there was a real creditor in the transaction that demanded repayment.

In determining whether a transaction constitutes a sham in substance, both a majority of the Courts of Appeals and the Tax Court have employed a flexible two-pronged analysis that focuses on two related factors, economic substance apart from tax consequences, and business purpose. See ACM Partnership, supra, at 247; Karr v. Commissioner, 924 F.2d 1018, 1023 (11th Cir. 1991); James v. Commissioner, 899 F.2d 905, 908-909 (10th Cir. 1990); Shriver v. Commissioner, 899 F.2d 724, 727 (8th Cir. 1990); Rose v. Commissioner, 868 F.2d 851, 853 (6th Cir. 1989); Kirchman v. Commissioner, supra, at 1492; Winn-Dixie, supra, at 280-281. Whether a transaction has economic substance is determined by an objective evaluation of how the transaction alters the taxpayer’s economic position, aside from tax benefits. See Kirchman, supra, at 1492. In doing so, it is appropriate to analyze the transaction in its entirety rather than isolate any single step. Id. at 1493-1494. Whether a transaction has legitimate business purpose is determined by a subjective analysis of the taxpayer's intent. See ACM Partnership, supra, at 247.

Three recent court opinions have addressed whether certain broad-based COLI transactions had sufficient economic substance and business purpose to permit the owners of the underlying policies to deduct interest incurred on policy loans under § 163. In each case, the court concluded that the COLI plans at issue lacked economic substance and business purpose.

The first of the three courts that have recently addressed broad-based COLI transactions is the United States Tax Court. See Winn-Dixie, supra. In Winn-Dixie, the taxpayer purchased a COLI plan comprised of 36,000 policies on the lives of its employees. The taxpayer purchased the plan pursuant to a pre-arranged scheme whereby the taxpayer would systematically borrow from the policies in order to pay premiums. The taxpayer paid an interest rate of 11.06% on policy loans, and the insurer provided the taxpayer with a loaned crediting rate of 10.66% on leveraged cash values, thereby producing a fixed spread of 40 basis points. In contrast, the insurer provided the taxpayer with a crediting rate of 4 percent on unborrowed cash values.

The promoters of the COLI plan in Winn-Dixie provided the taxpayer with detailed projections of costs and benefits expected from the plan over a 60-year period. Particularly, the projections indicated that, during each policy year, the plan would generate a pre-tax loss and a significant after-tax profit, attributable to deductions for policy loan interest and administrative fees. The plan contemplated that the taxpayer would maintain little net equity in the policies, relative to the size of the plan.

The court in Winn-Dixie first addressed whether the COLI plan possessed sufficient objective economic substance. The taxpayer argued that the COLI plan could produce tax-independent benefits if the insureds died earlier than anticipated, thereby producing unexpected death benefits. The court recognized that life insurance may be legitimate, even where its predictable cost exceeds its predictable benefits, if the policy protects the beneficiary against the financial consequences of the insured's untimely death. The court, however, found that the taxpayer did not purchase the plan to provide death benefit protection, noting the large number of geographically dispersed insureds and the fact that the employees remained insured even after their employment was terminated. Id. at 284-285. The court further observed that, although there would be some variation between the anticipated and actual mortality of the 36,000 insureds, such variations were not expected to significantly affect the plan. Viewing the COLI plan as a whole, and noting the annual discrepancy between pre-tax losses and after-tax profits set forth in the promotional material, the court found that the plan's only function was to reduce the taxpayer's income tax liabilities. Id. at 285. Thus, the court concluded the plan lacked economic substance.

The court in Winn-Dixie next addressed whether the taxpayer had a sufficient subjective business purpose for entering into the COLI transaction. The taxpayer argued that its business purpose for entering into the transaction was to generate funds to pay for the increasing cost of its employee benefits program, which included limited death benefits. The court rejected this argument, explaining that there was no indication that the COLI policies were tailored to fund the taxpayer's employee benefit plan, and that employees remained insured after they left the taxpayer's employ. Id. at 286. In addition, the court explained that even if the taxpayer had earmarked the COLI plan's tax savings to fund its employee benefits, that would not be sufficient to "breathe substance" into the transaction. Otherwise, reasoned the court, "every sham tax shelter device might succeed." Id. at 287. Moreover, the court noted that the taxpayer was offered an "exit strategy" to terminate the plan if new legal limitations were imposed upon taxpayer's interest deductions, thereby suggesting that the purported business purpose for the plan was not sufficient to maintain the plan without the plan's tax benefits. Id. at 288-289. Thus, the court concluded that the COLI plan served no business purpose for the taxpayer, other than to reduce its taxes.

The next two opinions that addressed broad-based COLI transactions were In re C.M. Holdings, Inc., 254 B.R. 578 (D. Del. 2000) and American Electric Power, Inc. v. United States ("A.E.P."), 136 F. Supp.2d 762 (S.D. Ohio 2001), which involved similar COLI transactions based upon policies issued by the same insurer. In C.M. Holdings and A.E.P., the taxpayers purchased COLI plans comprised of 1,430 and approximately 20,000 policies, respectively. The COLI plans in C.M. Holdings and A.E.P., in similar fashion to the COLI plan in Winn-Dixie, contemplated a scheme whereby the taxpayers would systematically borrow from the policies to pay premiums. The taxpayers in C.M. Holdings and A.E.P., before purchasing the COLI plans, received financial illustrations indicating that the COLI plans would generate annual pre-tax losses and significant after-tax profits, primarily attributable to deductions for policy loan interest. The courts in both cases described the features of the plans as follows: (1) high policy value on the first day of the policy; (2) maximum policy loans used to pay high premiums during the first three policy years; (3) zero net equity and maximum borrowing at the end of each policy year, perfected through the use of computer programs; (4) a variable interest rate provision whereby the taxpayer could choose the interest rate that it paid on policy loans; (5) a fixed spread between the policy loan rate and the loaned crediting rate, "with the counterintuitive result" that the higher the loan interest rate paid by the taxpayer, the greater the cash flow due to increased tax deductions; and (6) extremely high expense load components for the fourth through seventh policy years, which were used to create policyholder dividends that could be used to pay premiums. A.E.P., supra, at 777-778; C.M. Holdings, supra, at 596-597.

In addressing whether the COLI plans at issue lacked objective economic substance, the courts in C.M. Holdings and A.E.P. compared the plans' economic effects on a pre-tax and after-tax basis. The courts first noted that, according to the financial illustrations provided to the taxpayers before they purchased the COLI plans, the plans were projected to generate negative pre-tax cash flows and positive after-tax cash flows over the life of the plans.[27] The courts further explained that the taxpayers did not expect to derive material economic gain from the non-tax beneficial components of the COLI plans, i.e., tax deferred inside build-up and tax-free death benefits. Specifically, the courts reasoned that inside build-up was not a motivating factor since the COLI policies were designed to have zero net equity at the end of each policy year. A.E.P., supra, at 787-788; C.M. Holdings, supra, at 631-632. The courts further noted that the fixed spread between the policy loan interest rate and loaned crediting rate precluded the taxpayer from receiving any non-tax economic benefit from inside build-up, despite the fact that the policy loan rates themselves were variable.[28] A.E.P., supra, at 788; C.M. Holdings, supra, at 632. In concluding that the taxpayers did not purchase the COLI plans with an expectation of receiving death benefits, the courts reasoned that the

[27] The court in C.M. Holdings particularly observed that, even assuming that the taxpayer's COLI plan were to generate positive pre-tax cash flows in the fifty-third through eighty-first years of the plan, it would not confer economic substance upon the transaction because the taxpayer failed to establish that the aggregate present value cash flow from the plan provided a "reasonable return in the absence of loan interest deductions." See C.M. Holdings, supra, at 631.

[28] The court in A.E.P. explained that, although the policy loan interest rate was variable, which in turn varied the amount of tax savings derived from the transaction, that fact did "not imbue the plan with economic substance." A.E.P., supra, at 788.

policies were designed to be "mortality neutral," insofar as the parties expected that the cumulative COI charges paid by the taxpayers would equal the cumulative death benefits that the taxpayers would receive. A.E.P., supra, at 787; C.M. Holdings, supra, at 632-635. In addition to addressing whether the taxpayer sought to generate inside build-up and receive death benefits in excess of cost, the court in A.E.P. expressed particular concern that the parties, in designing the policies' interest rate provisions, exploited a loophole in the NAIC model bill, discussed supra at n.21, in an attempt to ensure that the taxpayer would always pay a policy loan interest rate in excess of the Moody's Corporate Average Rate. A.E.P., supra, at 789-790. In so doing, the court stated:

> When a transaction is structured so that the borrower actually benefits from a higher loan interest rate and the borrower is permitted to [choose] its own interest rate from a range of rates that begins with a rate that far exceeds the industry maximum, the interest rate component of the transaction lacks economic substance.

Id. at 790. Thus, the courts in C.M. Holdings and A.E.P. concluded that the COLI plans lacked economic substance.

The courts in C.M. Holdings and A.E.P. next addressed the parties' subjective business purpose for entering into the COLI transactions. The taxpayer in C.M. Holdings argued that it entered into the COLI transaction for the legitimate purpose of providing for the increasing cost of its employees' medical benefits, whereas the taxpayer in A.E.P. argued that it entered into the COLI transaction for the legitimate purpose of offsetting the cost of implementing FAS 106. Both courts rejected the taxpayers' arguments, emphasizing that the business purpose test is whether the underlying transaction has a legitimate purpose, not whether the taxpayer has a legitimate use for the after-tax cash flows generated by the transaction. A.E.P., supra, at 791-792; C.M. Holdings, supra, at 638. The court in C.M. Holdings particularly noted the taxpayer's concern with pending tax legislation, manifested by a "honeymoon letter" and an attempt to execute the transaction before Congressional hearings on COLI began, as further indication that the COLI plan's critical feature was its ability to generate interest deductions. C.M. Holdings, supra, at 640. Thus, finding that the earnings generated by the COLI plans were tax-driven, the courts concluded that the plans served no legitimate business purpose.

a. Whether the P1 and P2 Plans had Objective Economic Substance

We now address whether the P1 and P2 transactions at issue in this case have sufficient objective economic substance apart from their tax benefits, viewing the transaction as a whole. Unlike the parties involved in the three published COLI opinions, the parties in this case did not submit precise plan illustrations issued contemporaneously with the issuance of the P1 and P2 plans. Nevertheless, other materials dated prior to or recently after issuance of the P1 and P2 plans indicate that the primary purpose of the plans was to generate after-tax cash flows for Taxpayer through the use of policy loan interest deductions. Actuary A's illustration, dated just prior to issuance of the P1 plan, refers to the plan "as an investment" based on the "after-tax rate of return" generated by the "large write-off of the life insurance program." Broker's Date 2, Year 3 proposal with respect to the P2 plan similarly refers to the benefits of the proposed plan in terms of "after-tax outlays," with benefits generated by policy loan interest deductions. In this regard, the proposal also assures Taxpayer of Insurer's willingness to unwind the transaction in the event that Congress enacts adverse tax legislation, as indicated by the "honeymoon letter," dated Date 4, Year 3, subsequently provided to Taxpayer by Insurer. Most significantly, Actuary B's study of the P1 and P2 plans dated Month D, Year 4 sets forth the anticipated pre-tax and after-tax effects of the plan, and projects negative pre-tax cash flows from the plans for all but two of the years between Year 2 and Year 72. Particularly, Actuary B's study projects that, over a -year period, the P1 and P2 plans will result in combined pre-tax losses of ($x) and positive after-tax cash flows of $aa; this wide difference is primarily due to the interest deductions generated by policy loan interest deductions. The projections in Actuary B's study are consistent with Taxpayer's Year 12 description of the plans to bond rating agencies as "Insurance Designed to by 'Stripped'," and as possessing "Maximum Interest and Tax Benefits." The wide difference in this case between anticipated pre-tax losses and positive after-tax cash flows indicates that the P1 and P2 plans lacked economic substance apart from tax benefits. See A.E.P., supra, at 787; C.M. Holdings, supra, at 625-626; Winn-Dixie, supra, at 283-285.

The policies' interest rate provisions further indicate that policy loan interest deductions were the primary feature of the plan. Broker's Date 6, Year 3 letter to Taxpayer explains that Insurer fashioned the policies with fixed and variable interest rate options so that the interest that Taxpayer paid on policy loans would never decrease after the policies were issued; the fixed rate option was available if interest rates decreased, and the variable rate option was available if interest rates increased. The fixed interest rate rider, in particular, exploited a loophole in the NAIC model bill regarding policy loan interest limitations. By doing so, Taxpayer was able to pay interest on policy loans at a rate that far exceeded market interest rates. While Taxpayer paid high interest rates on policy loans, Insurer annually declared a loaned crediting rate under the fixed rate option in an amount that created the same pre-determined spread between the loaned crediting rate and policy loan interest rate as was available under the variable rate option. Accordingly, both Taxpayer's cost of borrowing and Insurer's profit were fixed regardless of the rate of interest Taxpayer paid on policy loans. The higher policy loan interest deduction generated by higher policy loan interest charges, coupled with the fixed cost of borrowing, led to the counter-intuitive result that Taxpayer actually benefitted more from the transactions on an after-tax basis as policy loan interest rates increased. See C.M. Holdings, supra, at 597, 632. Not surprisingly, when the usury laws of State B threatened to limit policy loan interest rates, the policies were transferred to a trust administered in State C, where no such limitations existed. As explained by the court in A.E.P., supra, at 790, the interest rate component of a transaction lacks economic substance where the borrower actually benefits from a higher loan interest rate and the borrower is allowed to choose its own interest rate, including those that far exceed the current market rates.

Taxpayer argues that the P1 and P2 plans had economic substance for four reasons. Taxpayer first argues the transactions materially changed its economic position because Taxpayer had significant cash values in the P1 and P2 policies and had the expectation of receiving significant death benefits. Specifically, Taxpayer argues that it paid $bb out-of-pocket for premiums during four of the first seven policy years. Taxpayer further argues that, at the end of the seventh policy years, the policies had accumulated death benefit protection of $cc and net equity of $dd. Taxpayer also contends that if everyone insured in the P1 and P2 plans died in the same year, it was entitled to receive death benefits from the policies, net of policy loans, of $ee in the first policy year, increasing to $ff during the sixteenth policy year. Additionally, Taxpayer maintains that, unlike the plans set forth in C.M. Holdings and A.E.P., the P1 and P2 plans were not designed to be mortality neutral because Taxpayer expects to receive $gg in death benefits in excess of the COI for the policies. Taxpayer further argues that, had it not leveraged the policies, it would receive total death benefits, less expenses, in the net amount of $hh.

Taxpayer correctly asserts that the expectation of inside build-up and death benefits are two non-tax benefits associated with owning life insurance. Nevertheless, we disagree with Taxpayer that the P1 and P2 plans provided Taxpayer with any economic benefits aside from generating tax deductions. Turning first to Taxpayer's expectation of accumulating inside build-up, we note that although Taxpayer temporarily accumulated cash value by paying cash for four of the first seven years' premiums, Taxpayer, Broker, and Insurer assumed from the inception of the plans that Taxpayer would have little or no net equity in the policies after the seventh policy year. Economic substance is determined on the basis of the P1 and P2 transactions as a whole, viewed in the aggregate over the life of the plans; we are required to weigh the fact that there was some economic benefit during any one year of the plan against the economic consequences of the plan over its duration. See C.M. Holdings, supra, at 629-631. Given the anticipated pre-tax losses that the P1 and P2 plans were expected to generate over their duration, the fact that Taxpayer generated cash value in the seventh policy year does not imbue the plans with economic substance.

Regarding Taxpayer's expectation of receiving death benefits from the P1 and P2 plans, Actuary B's study projects that the P1 and P2 plans, including expected net death benefits received, will result in negative pre-tax cash flows of ($x) over years. We agree with Taxpayer that, in some instances, it is inappropriate to analyze the economic benefits of life insurance in terms of pre-tax profit expectations because the predictable cost of maintaining life insurance may exceed predictable death benefits and nevertheless be justified by the financial protection that insurance provides against the insured's untimely death. What Taxpayer actually argues, then, is that its need for financial protection against the untimely death of its employees justifies the expected pre-tax cost of the P1 and P2 plans. In this case, however, Taxpayer purchased insurance on a large number of non-executive employees who remained covered even after leaving Taxpayer's employ. Thus, there was little likelihood that expected cash flows from the plan would be significantly affected by discrepancies between the insureds' actuarially anticipated mortality used to determined the COI and the insureds' actual mortality. See Winn-Dixie, supra, at 284-285. For that reason, whether Taxpayer could have generated a windfall from death benefits if many insureds died in the same year is irrelevant, since the likelihood of such an event is remote. Similarly, although the P1 and P2 plans are not mortality neutral in the same manner as the plans in C.M. Holdings and A.E.P., it is improbable that the actual mortality experience of the P1 and P2 plans will be sufficient to justify the plan's projected pre-tax cost.[29] Accordingly, we disagree with Taxpayer that its expectation of receiving death benefits confers economic substance upon the P1 and P2 plans.

We also disagree with Taxpayer's assertion that, because it would receive death benefits in the amount of $hh had it not borrowed from the P1 and P2 policies, the P1 and P2 plans possessed economic substance. Taxpayer attempts to analyze the economic effects of the transactions by assuming that the policy loans never occurred. This is inconsistent with the economic substance analysis performed by the three courts that have addressed COLI transactions. The proper economic substance analysis of a COLI transaction, as set forth by the courts, is to examine the objective economic effects of the entire transaction absent its tax benefits. This contemplates comparing the pre-tax and after-tax consequences of the transaction, including the cost of paying interest on policy loans. A.E.P., supra, at 787; C.M. Holdings, supra, at 625-626; Winn-Dixie, supra, at 281-285. Accordingly, we reject Taxpayer's analysis in this respect, which is based upon a non-existent set of facts.

Taxpayer's second of four arguments is that it had a legitimate non-tax motivation for electing the fixed rate loan provision, even when it resulted in an interest rate on policy loans that far exceeded current market rates. Specifically, Taxpayer contends:

> The [P2] policies purchased in [Year 3] offered a fixed rate rider that would permit [Taxpayer] to opt for a constant rate of interest over time. This feature could eliminate nearly all uncertainty from the funding capability of the product, and the feature was then added as a rider to the [P1] policies.

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[29] We also note that the Guaranteed Mortality Profit Refund and Fluctuation Reserve Contingency Payments set forth in the P2 policies will reduce any mortality fluctuations with respect to those policies.

We disagree. Taxpayer's actual cost of borrowing was the same under either the fixed or variable rate option, i.e., the pre-determined spread of Number G basis points for the P1 policies and Number H basis points for the P2 policies. We fail to see how the fixed rate option provided Taxpayer with more certain funding in comparison to the variable rate option, unless one considers the certainty of tax benefits generated by policy loan interest paid at a fixed rate regardless of current market conditions.[30] Indeed, a fixed loan rate provision would serve a non-tax purpose, for example, if it protected the borrower from subsequent interest rate increases.[31] In this case, however, Taxpayer derived greater cash flow on an after-tax basis as policy loan interest rates increased. For that reason, Broker's Date 6, Year 3 letter to Taxpayer indicates that the policies' fixed rate option was fashioned to protect Taxpayer in case interest rates subsequently decreased, thereby maintaining Taxpayer's after-tax rate of return without regard to market interest rate fluctuations. It is not surprising, therefore, that Taxpayer was entitled to annually elect either the fixed or variable rate option and never chose the variable rate even though market interest rates decreased after the policies became effective. Accordingly, contrary to taxpayer's assertions, the fixed rate provision was purely tax motivated.

Taxpayer's third of four arguments is that a revenue ruling and applicable case law support its position that the P1 and P2 plans have economic substance. Taxpayer

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[30] Taxpayer's description of the fixed rate option as providing certain funding for the plan is also inconsistent with the terms of the fixed rate rider, which permits Insurer to annually declare the loaned crediting rate. This is further indication that Taxpayer and Insurer understood that the annually declared loaned crediting rate under the fixed rate option would produce the identical spread as was expressly available under the variable rate option.

[31] Taxpayer cites the "Blue Book" explanation of certain amendments to § 264 in 1996 as indication that Congress approved of fixed loan interest rate provisions with respect to contracts purchased prior to June 21, 1986. See Staff of Joint Comm. on Taxation, 104th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in the 104th Congress 366 (Comm. Print 1996). Specifically, Congress in 1996 imposed limitations upon the policy loan interest rate that taxpayers could use to generate interest deductions, and set forth in § 264(e)(2)(B)(ii) an exclusion from such limitations for certain contracts with fixed rate provisions purchased prior to June 21, 1986. In providing this exclusion, however, Congress did not intend to permit interest deductions under § 163 for transactions that otherwise lacked economic substance and business purpose. See Winn-Dixie, supra, at 293 (explaining that "we are not persuaded that Congress, by enacting and amending section 264 . . . , intended to allow interest deductions under section 163 based on transactions that lacked either economic substance or business purpose"). Thus, we must determine whether the P1 and P2 transactions as a whole are substantive shams before turning to the legislative history underlying § 264.

maintains that Rev. Rul. 71-309, 1971-2 C.B. 168, where the Service concluded that interest incurred on policy loans was deductible, is controlling. The ruling is similar to the facts in this case in that the taxpayer in the ruling satisfied the four-out-of-seven test set forth in § 264, and intended to pay the premiums for the eighth and all succeeding policy years under a plan that contemplated the systematic borrowing of part or all of the increases in the cash value of the policy. Nevertheless, we consider the ruling to be inapposite. The ruling involved one life insurance policy, with the policyholder's wife and children designated as beneficiaries. In contrast, the facts in this case involve broad-based plans comprising many insured lives where it is contemplated that pre-tax cash flows, net of expected death benefits, will be negative over the duration of the plans. The ruling also assumes that, except for the policy loans, no other taxpayer-adverse factors were present. By comparison, in this case, additional factors not present in the ruling indicate that the P1 and P2 plans lack economic substance.[32]

Taxpayer also contends that the Fifth Circuit's economic substance analysis in Campbell v. Cen-Tex, Inc., 377 F.2d 688 (5th Cir 1967) is applicable to the facts in this case. We disagree. In Cen-Tex, the taxpayer was a family-owned corporation that purchased leveraged life insurance policies on the lives of its employee-stockholders. On the basis of the parties' stipulation that the insurance policies in issue were purchased to meet the taxpayer's deferred compensation obligations and to provide insurance on its key employees, the court concluded that the transaction possessed economic substance because the transaction produced benefits other than tax benefits. The court in Winn-Dixie, in rejecting the argument that Cen-Tex was controlling, distinguished Winn-Dixie's COLI transaction by emphasizing the plan's "predictable negative cash flow" absent its tax benefits. Winn-Dixie, supra, at 290. Likewise, the court in C.M. Holdings distinguished Cen-Tex, by noting that the plan in Cen-Tex was purchased to provide the taxpayer with insurance protection from financial losses in the event that its key employees died. C.M. Holdings, supra, at 642. Similar to the plans in Winn-Dixie and C.M. Holdings, the P1 and P2 plans in this case are expected to generate predictable pre-tax losses over their duration, and are broad-based plans that are not targeted towards Taxpayer's key employees. Accordingly, we conclude that Cen-Tex is not controlling in this case.

In addition, Taxpayer cites Shirar v. Commissioner, 916 F.2d 1414 (9th Cir. 1990) as instructive. Shirar is distinguishable from the facts in this case because the facts in Shirar involved one policy purchased to fund potential estate tax liabilities and the

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[32] The ruling does not provide that every leveraged life insurance transaction that satisfies the four-out-of-seven test has economic substance per se. Cf. Winn-Dixie, supra, at 292 (explaining that "while the parties agree that [the taxpayer's] COLI plan meets the four-out-of-seven test . . . section 264 does not confer a right upon [the taxpayer] to take the deduction that would not otherwise be allowable under section 163").

taxpayer's plan of purchase contemplated the accumulation of cash value and an expectation of receiving death benefits in excess of the cost of the policies.

Taxpayer's last argument is that the Service cannot use Taxpayer's pattern of borrowing, which it claims satisfies § 264, as a basis for concluding that the P1 and P2 plans lack economic substance for purposes of § 163. Although Taxpayer acknowledges that compliance with § 264 does not ensure deductibility of policy loans under § 163, Taxpayer contends that the Service cannot use Taxpayer's decision to borrow heavily from policy values in the eighth policy year as a negative factor in analyzing the economic substance of the P1 and P2 plans. Taxpayer further argues that "Section 264 represents Congress' decision to draw a clear line between abusive and permissible borrowing against life insurance policies."

We disagree. Section 264 only applies to what is otherwise allowable under § 163; thus, a transaction lacking economic substance and business purpose does not generate deductible interest under § 163, regardless of whether it meets the requirements of § 264. See C.M. Holdings, supra, at 624; Winn-Dixie, supra, at 292. As indicated by Rev. Rul. 71-309, transactions generating policy loan interest may possess sufficient economic substance for purposes of § 163 although the taxpayer intends to pay the premiums for the eighth and all succeeding policy years by borrowing from increases in the policy's cash value. Nevertheless, an analysis of that transaction's tax-independent economic substance must take such borrowing into account because the borrowing will typically affect the transaction's non-tax economic consequences by increasing interest costs and reducing net cash values and net death benefits. Therefore, we consider it appropriate to consider Taxpayer's decision to borrow from the P1 and P2 policies' cash values during the eighth and all succeeding policy years in analyzing the economic substance of the plans. Moreover, other factors apart from Taxpayer's particular pattern of borrowing indicate that the P1 and P2 plans lack economic substance, including anticipated aggregate pre-tax losses and the policy loan interest rate provisions.

Accordingly, we conclude that Taxpayer's P1 and P2 plans lack objective economic substance, apart from generating tax benefits.

b. Whether the P1 and P2 Plans had a Legitimate Subjective Business Purpose

We now address whether Taxpayer had a subjective business purpose for engaging in the P1 and P2 transactions, other than tax avoidance. Taxpayer alleges that, before entering into the P1 and P2 transactions, it had become concerned with the increasing pay-as-you-go costs associated with its post-retirement death benefit program, and that it decided to implement the P1 and P2 plans as a means of paying for such costs. Particularly, Taxpayer contends that, if left "unchecked," its undiscounted future liabilities for post-retirement death benefits as of mid-Year 4 could have totaled a maximum of $jj.[33]

Indeed, both Actuary A's Date 1, Year 2 letter and Broker's Date 2, Year 3 proposal indicate that Taxpayer purchased the P1 and P2 plans, in part, to fund its post-retirement death benefit liabilities. Despite Taxpayer's assertions, however, there is no documentation indicating that the anticipated death benefits payable from the P1 and P2 policies were tailored to fund those liabilities. Rather, it appears that Taxpayer structured the plans in order to pay for its post-retirement death benefit liabilities through tax savings, rather than death benefits. We first note that the policies remained in effect even if individual insureds left Taxpayer's employ prior to retirement. Moreover, Actuary B's projections of cash flows from the plans, completed only one year after Taxpayer purchased the P2 plan, indicate that the P1 and P2 policies' anticipated death benefits and net cash values alone would not satisfy Taxpayer's premium and policy loan obligations. Only when the tax benefits of the interest deductions are taken into account do the plans generate cash flow to pay for Taxpayer's liabilities. The "honeymoon letter," which allowed Taxpayer to terminate the P2 policies in the event Congress enacted new legal restrictions on interest deductions, further indicates that the P2 policies would not provide Taxpayer with satisfactory cash flow absent the tax benefits derived from policy loan interest deductions. See C.M. Holdings, supra, at 640; Winn-Dixie, supra, at 288-289. In this vein, Broker's Date 2, Year 3 proposal presented to Taxpayer before it purchased the P2 plan sets forth after-tax cash-flow projections for COLI plans issued by various insurers, so that Taxpayer could compare the cumulative net after-tax effects of each plan.

Furthermore, Actuary B's study also projects that the P1 and P2 plans will generate tax savings to times greater than was needed to fund Taxpayer's post-retirement death benefit liabilities, and recommends that Taxpayer "utilize some of the extra gains for covering the liabilities of other post-retirement programs." Similarly, Broker's document, "[Sub] Dividend Scenarios," suggests that Taxpayer, in addition to paying for its retired employee's death benefits, use the after-tax cash flow from the P1 and P2 plans to pay for post-retirement health care costs; executive salary continuation; dividends to Taxpayer's shareholders; deferred benefits for Taxpayer's directors; and "other" expenses. In addition, although the P1 and P2 plans were expected to generate more than enough after-tax cash flow to provide for Taxpayer's cost of providing post-retirement death benefits, Taxpayer subsequently began recovering that cost from its ratepayers, thereby allowing Taxpayer to use all of the cash flow from the plans for purposes other than its initial ostensible purpose. These are further indications that

[33] Taxpayer's maximum liability is based on a Year 4 study which assumes that all current and future employees would be eligible to receive post-retirement death benefits. Accordingly, the study sets forth various scenarios depending upon employee population growth rate, attrition, and wage inflation.

Taxpayer made little effort to tailor the P1 and P2 plans in an effort to meet its post-retirement death benefit liabilities.

We also note that, even after purchasing the P1 and P2 policies, Taxpayer separately maintained a plan operated by Administrator B that administered Taxpayer's post-retirement death benefit program on a pay-as-you-go basis. Thus, Taxpayer maintains that it paid Insurer for insurance in order to fund future payments to Administrator B for coverage of the same liabilities. Taxpayer, therefore, incurred redundant administrative expenses by maintaining two separate insurance plans to pay coverage for the same liability, i.e., the lives of its retired employees. Were the P1 and P2 policies primarily designed to fund Taxpayer's liability for its employee's post-retirement death benefits, we doubt that Taxpayer would have needed to maintain its plan with Administrator B.

Taxpayer argues that Actuary B's Year 4 study does not accurately reflect Taxpayer's liabilities for post-retirement death benefits as they existed when Taxpayer purchased the P1 and P2 plans. Specifically, Taxpayer contends that Actuary B's estimates of Taxpayer's liabilities are not helpful because those estimates incorporate cost-reducing changes that Taxpayer implemented in its benefit program on Date 12, Year 4, subsequent to the date in which Taxpayer purchased the P1 and P2 plans. Taxpayer maintains that its own Year 4 study, where it estimated its maximum liability at $jj, is more accurate than Actuary B's study because Taxpayer's study projects liabilities on the basis of Taxpayer's employee benefit program as it existed when Taxpayer purchased the P1 and P2 policies.

We disagree. Broker's Date 2, Year 3 proposal to Taxpayer indicates that, prior to purchasing the P1 and P2 plans, Taxpayer had decided to implement a "new" employee benefit program that would reduce Taxpayer's liabilities. The proposal further explains that, prior to purchasing the P1 plan, Taxpayer decided to limit eligibility in its existing program to employees aged and over, but decided to allow all existing employees the opportunity to stay in the program due to "moral or perhaps legal age discrimination" concerns. Accordingly, when Taxpayer purchased the P1 and P2 plans, Taxpayer was also contemplating various cost-reducing changes in its employee benefits program. Actuary B's study is the most accurate estimate available of Taxpayer's post-retirement death benefit liability, because that study incorporates cost-reducing changes similar to those that Taxpayer was considering at the time that it purchased the P1 and P2 plans. Given that Taxpayer was anticipating reducing employee eligibility for post-retirement death benefits when it purchased the P1 and P2 plans, we also doubt the reliability of Taxpayer's own calculated estimates completed in Year 4, which assume that all current and future employees will continue to receive such benefits.[34]

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[34] In addition, a letter by Broker to Taxpayer dated Date 13, Year 2, indicates that approximately g% of Taxpayer's employees did not participate in its group life insurance program even prior to the implementation of Taxpayer's new program on

Therefore, we conclude that Taxpayer purchased the P1 and P2 plans to fund its employee death benefit liabilities and other unrelated liabilities with the plans' positive after-tax cash flow, which was solely generated by policy loan interest deductions. Accordingly, Taxpayer's liability for post-retirement employee death benefits is no different than the employee death benefits discussed in Winn-Dixie. Winn-Dixie, supra, at 288. That a taxpayer has a valid use for the after-tax gains generated from a transaction does not confer upon the transaction a valid business purpose. See A.E.P., supra, at 791-792; Winn-Dixie, supra, at 287. The possibility that the tax benefits from the P1 and P2 plans could have been used as a general source of funds for Taxpayer's post-retirement death benefit obligations, or any other business purpose, does not alter the fact that the P1 and P2 plan served only to reduce Taxpayer's income tax liabilities. Accordingly, we conclude that Taxpayer did not engage in the P1 and P2 transactions with a legitimate business purpose other than tax avoidance.

On the basis of all the aforementioned considerations, we find that Taxpayer purchased the P1 and P2 policies pursuant to a plan the only function of which was to generate interest deductions in order to offset income from other sources and thereby significantly reduce its income tax liability. We conclude that Taxpayer's broad-based P1 and P2 plans were shams in substance. Accordingly, Taxpayer is not permitted to claim interest deductions pursuant to § 163 with respect to interest incurred on P1 and P2 policy loans for Years 11 through 15.

2. Whether Taxpayer paid four of the first seven years' annual premiums for the P1 and P2 policies by a means other than indebtedness, thereby satisfying the "four-out-of-seven" safe harbor set forth at § 264(c)(1) and the accompanying regulations.

The parties dispute whether Taxpayer met the requirements of the four-out-of-seven safe harbor set forth in § 264(c)(1) with respect to Taxpayer's premium payments for the P1 and P2 policies. Since we have concluded that Taxpayer may not claim deductions for the interest incurred on policy loans because the P1 and P2 plans are substantive shams for purposes of § 163, our determination of whether Taxpayer satisfied the four-out-of-seven test will not affect our ultimate conclusion that the interest incurred on the P1 and P2 policy loans is not deductible. Nevertheless, we shall address whether Taxpayer satisfied the four-out-of-seven test on the assumption that the policy loan interest was otherwise legitimate.

Section 264(a)(3) generally disallows deductions for interest paid or accrued on loans taken against a life insurance policy "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 the policy. Section 264(c)(1) provides an exception to this general

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Date 12, Year 4.

rule. Specifically, § 264(c)(1) provides that if no part of any four annual premiums due in the first seven-year period of an insurance contract is financed by means of indebtedness, then the general rule of § 264(a)(3) will not apply. The flush language of § 264(c) further provides that for purposes of applying the four-out-of-seven test, "if there is a substantial increase in premiums on the contract, a new 7-year period . . . with respect to such contract shall commence on the date the first such increased premium is paid." See also Treas. Reg. § 1.264-4(d)(1)(i). The legislative history of § 264 indicates the Congressional intent underlying § 264(c)(1) and the flush language. In relevant part, the legislative history provides:

> The interest deduction is to be allowed if there is no borrowing with respect to any four of the annual premiums payable on the insurance . . . contract in the first 7 years of the contract. However, to prevent avoidance of this provision by taking out a contract with very low premiums for the first 4 years, with the premiums being substantially greater thereafter, the bill contains a rule relating to situations of this type. It is provided that the 7-year period referred to above is to commence again at any time there is substantial increase in the premiums payable under the insurance . . . contract.

S. Rep. No. 830 (1964), reprinted in 1964-1 C.B. (Part 2) 505, 583 (1964). Thus, the flush language contemplates situations whereby a taxpayer attempts to circumvent the meaning of the four-out-of-seven test by paying four very low annual premiums without borrowing, while paying substantially higher premiums for other years with borrowing.

The parties in this case first dispute the effect of the P2 policies' volume discount upon the application of the four-out-of-seven test. Since Taxpayer received a volume discount refund of $kk with respect to the first policy year of the P2 policies, the parties dispute whether the first policy year's premium should be measured on a basis net of the volume discount for purposes of the four-out-of-seven test. Assuming that the first policy year's premium is measured on a net basis, the parties also differ as to whether net premiums for the second policy year represent a substantial increase from the net premiums payable in the first policy year, thereby triggering a new four-out-of-seven testing period commencing in the second policy year. Since Taxpayer borrowed from the P2 policies during the second, third, fourth, and eighth policy years, Taxpayer would not satisfy the four-out-of-seven test if the second policy year's net premiums represented a substantial increase from the first policy year's net premiums.

Given the facts of this case, even if we were to accept the argument that it is appropriate to measure premiums on a net basis in applying the four-out-of-seven test, there would not be a "substantial increase" in premiums from the first to second policy years. The second year's premiums, net of the Guaranteed Mortality and Fluctuation Reserve Contingency Refunds, represent only a w% increase over the net premiums for the first policy year. There are no similar increases in the net premiums for subsequent years, and the premium refunds under the policies are not payable or determinable until the end of each policy year. Therefore, the w% increase in net premiums from the first to second policy years is not a “substantial increase” under § 264(c). Accordingly, we reject the argument that the volume discount payable with respect to the first policy year of the P2 policies precludes the Taxpayer from meeting the four-out-of-seven test.

The parties next dispute whether the Guaranteed Mortality and Fluctuation Reserve Contingency Refunds paid with respect to the second through fourth policy years of the P2 policies should be used to allocate a portion of the loans in those years to the first policy year. Treasury Reg. § 1.264-4(d)(1)(ii) provides in part:

> For purposes of subdivision (i) of this subparagraph, if during a 7-year period referred to in such subdivision the taxpayer . . . 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 . . . and then attributable to premiums for prior policy years beginning with the most recent policy year . . .

An example in the regulations indicates that this provision contemplates situations where a taxpayer borrows from a policy an amount in excess of that policy’s “annual gross premium” in the year of the borrowing. See Treas. Reg. § 1.264-4(d)(1)(iv), ex. (1). In such an instance, the loan is first considered attributable to the current year’s premiums, and any excess borrowing is deemed attributable to prior years’ premiums.

Taxpayer’s P2 policy loans for the second through fourth policy years were equal to the gross annual policy premiums for those years, but less than the premiums actually paid, net of the Guaranteed Mortality and Fluctuation Reserve Contingency Refunds. Thus, if we consider the annual premiums for the second through fourth policy years on a net basis, the loans for such years would exceed such premiums, and the excess would be deemed as borrowing attributable to the first policy year’s premium. Taxpayer, therefore, would be deemed to have borrowed from the policy for the first four policy years, and thereby fail the requirements of the four-out-of-seven safe harbor.

We disagree that the premiums for the second through fourth policy years of the P2 policies should be viewed net of the Guaranteed Mortality and Fluctuation Reserve Contingency Refunds for purposes of Treas. Reg. § 1.264-4(d)(1)(ii). Example (1), set forth at § 1.264-4(d)(1)(iv) of the regulations, suggests that premiums should be viewed on a gross basis for purposes of Treas. Reg. § 1.264-4(d)(1)(ii). This is also consistent with Treas. Reg. § 1.264-4(c)(1)(ii), which measures certain premium fluctuations in terms of “stated annual premiums due on a contract.” These provisions in the regulations were not intended to measure premiums net of experience-based refunds or dividends; otherwise, a taxpayer attempting to comply with § 264 could not be certain that future contingent refund payments would cause policy loans to fail the four-out-of-seven test.[35] We also note that the Guaranteed Mortality and Fluctuation Reserve Contingency Refunds for the second though fourth policy years represented only x% of the gross premium due during those years. This is not akin to the situation contemplated in Example (1) of the Treas. Reg. § 1.264-4(d)(1)(iv), where a taxpayer pays the first four policy premiums without borrowing and essentially borrows from those premiums in the fifth policy year by borrowing far in excess of the fifth year's gross annual premium. Accordingly, we reject the argument that premiums for the P2 policies should be viewed on a net basis for purposes of applying Treas. Reg. § 1.264-4(d)(1)(ii).

Lastly, the parties dispute whether the fixed policy loan interest rate rider, attached to the P1 policies in Year 3, Number J months after the policies were issued, results in a new four-out-of-seven testing period for the P1 policies beginning in the second policy year. Particularly, the parties dispute whether the rider constitutes such a substantial change in the P1 policies that the policies should be deemed reissued in Year 3. Since Taxpayer borrowed from the P1 policies during the second, third, fourth, and eighth policy years, Taxpayer would not satisfy the four-out-of-seven test if the P1 policies were deemed reissued in Year 3.

The parties dispute the applicability of cases supporting the principle that, for purposes of § 1001, changes in the interest rates of a debt instrument may result in a taxable exchange of that debt instrument. <u>See, e.g.</u>, <u>Emery v. Commissioner</u>, 166 F.2d 27 (2nd Cir. 1948) (holding that exchange of bonds for new bonds with lower interest rates and extended maturity dates was a taxable event). In this case, however, the issue is not whether the P1 policy loans were exchanged for new loans upon the effective date of the fixed rate rider; rather, the issue is whether the P1 policies used to secure policy loans changed so substantially as to commence a new 7-year testing period for purposes of § 264(c)(1). Accordingly, the cases cited by the parties concerning exchanges of debt instruments are not applicable in the present case.

The legislative history underlying the enactment in 1986 of the $50,000 per policy loan limitation presently set forth at § 264(e)(1) is helpful. As previously discussed, the $50,000 per policy limitation is not applicable to policies issued prior to June 20, 1986. The following colloquy between Senator Dole and Senator Packwood addresses whether a policy issued prior to June 20, 1986, will be subject to the $50,000 per policy limitation when certain changes to the policy are implemented after that date:

> Mr. DOLE. Section 1003 of H.R. 3838 limits the interest deduction on indebtedness in excess of $50,000 per insured under certain life

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[35] This is distinguishable from a situation where a premium refund is a pre-arranged factual sham. <u>See</u> <u>C.M. Holdings</u>, <u>supra</u>, at 646 (explaining that the premium for purposes of the four-out-of-seven test is determined net of loading dividends that were determined to be factual shams).

> insurance policies. . . . The limitation applies only to indebtedness under contracts purchased after June 20, 1986.
>
> Concern has been expressed about whether this provision will apply to a policy purchased on or before June 20, 1986, if the policy is changed in a way that was contemplated by the parties and is customary with respect to such insurance. I would appreciate confirmation of my understanding that none of the following changes to a policy would be treated as the purchase of a new policy: A change in the owner of the policy, the exercise of an option or a right granted under a contract as originally issued -- including the substitution of insured but excluding conversion to term insurance -- <u>or a change in administrative provisions, loan rates, or any other item that does not affect the major terms of the policy</u>. However, a policy exchanged for a policy issued by a different insurance company would be treated as a new policy.
>
> Mr. PACKWOOD. Your understanding is correct.

132 Cong. Rec. S13956-57 (Sept. 27, 1986) (emphasis added). Commenting on this colloquy, Chairman Rostenkowski further added:

> With respect to the colloquies between Senator Dole and Senator Packwood . . . I am particularly concerned . . . by statements which seem to validate the ability to substitute insureds under a policy and qualify under the grandfather provisions. This issue was never discussed, and therefore never agreed to, by the conferees. In addition, I would like to clarify that certain factual determinations under this provision would be made by the Internal Revenue Service and the courts.

132 Cong. Rec. E3391 (Oct. 2, 1986)

The legislative history suggests that changes in a life insurance policy will not cause the policy to be considered reissued for purposes of § 264(c)(1) unless those changes affect the fundamental terms of the policy. In this case, the retroactive attachment of the fixed rate rider was solely intended to ensure that the P1 policies would generate policy loan interest deductions at a rate no lower than the applicable Moody's rate in effect when the policies were issued. Taxpayer and <u>Insurer</u> understood that the spread between the loaned crediting rate and the policy loan interest rate would be identical under either the variable or fixed rate option; thus, Taxpayer did not generate higher net cash values for any particular year by choosing the fixed rate option over the variable rate option. Therefore, the fixed rate option was not designed to affect Taxpayer's net cash value in the policies or increase its net death benefits receivable. Although the fixed rate rider may have been tax-motivated, it was not fashioned to avoid the particular requirements of the four-out-of-seven test. Accordingly, we conclude that the retroactive attachment of the fixed interest rate rider to the P1 policies did not result in a new 7-year testing period for purposes of § 264(c)(1).

On the basis of the aforementioned considerations, we conclude that Taxpayer satisfied the requirements of the four-out-of-seven safe harbor with respect to its payment of premiums for the P1 and P2 policies. Nevertheless, because we also conclude that the P1 and P2 plans were shams in substance, Taxpayer is not permitted to claim interest deductions on policy loans during the taxable years at issue.

CAVEAT(S)

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.