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Internal Revenue Service
Technical Advice Memorandum

SEP 29 1998

Name of Taxpayer:

Taxpayer's Address:
EIN:
Year(s) Involved:
Conferences of Right:

Legend:
Request Date =
State A =
Insurer =
Carrier =
Administrator =
Number B =
Amount C =
Number D =
Number E =
Form F =
Amounts G =
Amount H =
State I =
Amount J =
Date K =
Number L =
Amount M =
Amount N =
Year S =
Year T =
Year U =
Year V =
Year X =
Year Z =
Month 1 =
Policy Date =
endorsements =

Insurance Agent =
Consultants =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =

By memorandum dated Request Date, the District Director of State A and Taxpayer requested technical advice with respect to the federal tax treatment of interest deductions claimed under certain corporate owned life insurance (COLI) contracts.

Issues

The first issue is whether deductions of Amounts G in fiscal years Year T, U and V, respectively, relating to Taxpayer's COLI contracts should be disallowed because either (1) the amounts claimed as deductions are not interest paid or accrued within the taxable year on indebtedness as required for a deduction under section 163 of the Internal Revenue Code (Code); or (2) the relationship of the debt to the annual premiums due fails to satisfy the "4 out of 7" test of section 264(c)(l) on interest not otherwise disallowed under section 264(a) (4).[1] We conclude, for the reasons described below, that these deductions should be disallowed. Second, the Taxpayer has requested, under section 7805(b), that the Service limit the retroactive application of any adverse conclusions drawn herein that limit Taxpayer's deductions for the taxable years T, U and V.

Facts

Taxpayer is principally engaged in manufacturing and marketing products for the health and funeral industries, both directly and indirectly, through domestic and foreign subsidiaries and affiliates. Taxpayer is an accrual basis taxpayer with a tax year ending Date 2 and is subject to the audit jurisdiction of the District Director of the State A District. The taxable years at issue in this request are Years T, U, and V. During Year T, Taxpayer employed a total of approximately Number B individuals.

All of the issues presented involve Taxpayer's purchase of COLI contracts covering a large group of its employees. In general, COLI refers to life insurance purchased by non-natural persons (generally corporate employers) insuring the life of any officer, employee, director, or any person financially interested in, any trade or business currently or formerly carried on by the taxpayer. The advantage of broad-based COLI programs is the ability to maximize the after-tax benefits while attempting to meet the restrictions under the Code on borrowing secured by life insurance contracts.

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[1] Section 264(a)(4) disallows any interest deduction paid or accrued on any indebtedness with respect to one or more life insurance policies owned by a taxpayer covering the life of any individual who is an officer or employee of, or financially interested in, any trade or business carried on by the taxpayer to the extent that the aggregate amount of the indebtedness with respect to policies covering such individual exceeds $50,000.

In Year S, the Insurance Agent and the Consultants made proposals to Taxpayer under which a large group of life insurance policies would be purchased pursuant to a program under which the premiums for the first three policy years would be paid by loans secured by the policies' cash surrender value. The next four years' premiums would be paid through a combination of large dividends' paid concurrently with the due date of the premiums together with policy surrenders. Projections of the after-tax benefits of the proposed program were provided by the Insurance Agent to the Taxpayer based on four different assumed corporate income tax rates 'and two different level annual premium charges.

The Insurance Agent was in a position to reassure Taxpayer as to the expectations that the performance would track the proposals due to past correspondence with the Insurer on such issues as the likelihood that dividends would be paid on the scale described in the illustrations. One memorandum from the Insurer to the Insurance Agent stated:

> The premium expense charges are significantly higher than anticipated expenses. During the first 14 policy years [when investment-related dividends would first be available the entire dividend is based on the difference between expense charges and expenses. Because of the source of these dividends, they are paid at the time premiums are paid under current practice.... [B]y law, life insurance dividends can't be guaranteed.... However, in my opinion adequate provision has been made for commissions, administrative expenses, and taxes under current laws, so I believe the dividends illustrated have a high degree of integrity.

A letter dated Date 3 to the Taxpayer's Board of Director's Finance Committee succinctly described the contemplated advantages of the proposed program:

> [M]anagement [has] recommended a financial tax-leveraged proposal which would significantly improve cash flow, net income and would not materially compete for other uses of capital. The concept is a corporate-owned life insurance program ("COLI"). A corporate-owned life insurance program involves buying life insurance policies on employees, with their prior consent, naming the Taxpayer as beneficiary. COLI programs provide unique tax advantages to the corporation, such as, borrowing against cash values with the

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[2] This expectation was borne out by the payment of dividends on the first day of each policy year, starting on the issue date, that have corresponded closely in amount and timing to the pre-sale illustrations.

interest being tax deductible and the eventual receipt of the life insurance proceeds tax free.

At least two presentations were made to Taxpayer before a decision to purchase was made by Taxpayer's Board on Date 4. The presentation outline for one of them described COLI as "an investment vehicle which provides substantial positive cash flow.... With the build-up of the policies' cash values, Taxpayer will be able to offset premium payments through non-recourse policy loans and dividends." Another presentation's materials described the program as "an investment in the insurable values of Taxpayer employees to increase cash flows through reduced taxes."

Other than the expected tax benefits, the materials for the two presentations also noted that the COLI Plan could be used to finance future health care and other employee benefits with any excess benefits available for general corporate purposes. This dual purpose -- but with an emphasis on the tax benefits -- for the program was discussed in a letter dated Date 5 (shortly after the issuance of the policies) from Taxpayer's President and Chief Executive Officer to the Number D employees[3] who were to be insured under the COLI Plan:

> During the last several years, we experienced tremendous increases in our health care costs.... We continuously explore effective ways to fund this growing responsibility to our employees and at the same time, assure our company's financial future and continued success. One program we have been evaluating is a life insurance based investment program.... The [COLI] program contemplated by the Taxpayer, involves buying life insurance policies on employees with the Taxpayer as the beneficiary....
>
> While life insurance is the vehicle for this particular investment, the program has nothing to do with employee benefits as we normally view them. This is strictly an investment strategy that permits the Taxpayer to receive very favorable tax treatment.

Taxpayer's Board of Directors decide to purchase the COLI Plan using Form F on Date 4. The Number D policies under the COLI Plan were issued by Insurer with effective dates of Policy Date, Year T.[4] The policies were governed by the State A laws.

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[3] This group represents approximately 38 percent of Taxpayer's domestic work force.

[4] The COLI contracts were assumed by Carrier in Year V when Insurer became insolvent. The term "Insurer," where used for periods after that date, refers to Carrier rather than to the

A single application was filed for the Number D employees that had given their written consent to Taxpayer's purchase of insurance on their lives. No questions were asked relating to individual characteristics of the insureds that might affect their insurability such as occupation or health. Under the "remarks, details, and special request" section of the application, the following notations appear:

> Policy loan interest payable in arrears.
>
> Policy loans should be made in accordance with instructions received from the client company or its agent from time to time.
>
> Policy loan interest rate adjustable.
>
> Dividends should be paid in cash or credited to policy value using the same principles and calculation formulas used in the preparing the attached illustration.
>
> Issue as Form F.

Shortly thereafter, on Date 1, Taxpayer gave Insurer the census data on the individuals to be insured. On that date, Taxpayer also entered into a service agreement with the Insurance Agent under which it was to perform a number of tasks, including the provision of annual plan summaries. Insurance Agent prepares the summaries from reports generated by its co-administrator of the COLI Plan, Administrator. The two entities prepared issue illustrations at or around the time of the purchase of the COLI Plan, plus the following annual items: (a) periodic reports summarizing the total annual activity for all of the policies, (b) plan reviews prepared at the end of each policy year reporting the current actual performance of the COLI Plan and projecting the Plan's future performance, (c) minimum payment schedules (included in the plan reviews) analyzing the annual loan, premium, and other policy transactions occurring within the age and sex groups in the policy population, and (d) summaries of amounts due itemizing policy charges, payment offsets (such as loans, dividends) and billing Taxpayer for any cash payments due.

The policy illustrations received by Taxpayer projected positive cash flows and earnings in every policy year, predicated on obtaining the full tax benefit from interest deductions generated by non-recourse policy loans. Although illustrations

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initial issuer. The administration of the contract, most notably the timing and amount of the loading dividends and the continued close correspondence of the COLI program to the pre-sale illustrations, did not change upon substitution of insurance companies.

are not guarantees, correspondence subsequent to the purchase makes clear the importance of the plan operating as originally contemplated. For instance, when the mortality costs to Insurer ended up being lower than the mortality charges being paid by the holders of Policy F, Insurer made adjustments and assured the policyholders in writing of its intent to "maintain the integrity of product performance and the profit levels of the original pricing assumptions" and to "assure the integrity of Insurer's illustrations."

In reply to these assurances, the Insurance Agent wrote:

> Our clients relied on Insurer's illustrated mortality in making financial decisions to acquire Insurer's COLI products on a broad base of their employees. With actual mortality significantly less than illustrated mortality, many clients are experiencing a P&L and cash flow loss when based upon the issue illustration they had expected and budgeted for a P&L and cash flow gain. As you know, the executives who made the decisions to acquire Insurer's COLI product, based upon Insurer's original financial illustrations, are concerned with and are measured on their company's financial results over a short period of time....
>
> These clients find some comfort in your written assurances that the difference between actual mortality and the mortality illustrated by Insurer will be made up with interest through a mortality dividend.... Equally important is the amount of the contingency reserve and thus the amount of the mortality dividend to be paid in Year V.

This exchange is yet one more indication of the intention of all parties -- both prior to the purchase and after -- that the COLI Plan produce, as closely as possible, the illustrated results.

The total life insurance in force under the COLI contracts during Year T was approximately Amount M in potential death benefits. Taxpayer has kept all of the COLI contracts in force except those under which the insured has died. Through the sixth policy year, Insurer has paid Taxpayer aggregate gross death benefits of Amount C and net death benefits of approximately Amount N.[5]

The COLI contracts were issued on Form F, a life insurance contract first filed with state insurance regulatory authorities in Year P. Form F is an increasing death benefit, fixed premium, whole life insurance contract form, subject to the terms of

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[5] There is a minor difference in the calculation of this amount between the Taxpayer and the Field that is not material to the analysis in this memorandum.

several endorsements, intended for use in the COLI market. The paragraphs below describe the relevant provisions of Form F, incorporating the terms of all endorsements included with the contract.[6]

Premiums -- Each of the Number D COLI contracts provides for either of two level annual premiums: Amount H or Amount J. If the premium is not paid when due, the policy automatically becomes paid up on the basis of net single premium factors applied to the policy value (after satisfaction of any policy loans) although the policyholder can elect, within three months of default, to receive extended term insurance instead.

Death Benefit -- The initial death benefit (also referred to as the specified amount) for each of the Number D COLI contracts is based upon the individual insured's sex and age (but no other underwriting factors), assuming an annual premium of either Amount H or Amount J payable until death.[8] The death benefit is contractually defined as the greater of (a) the specified amount shown on the specifications page, (b) the policy value on a given date divided by the specified net single premium factors, and (c) the amount required for the policy to qualify as life insurance under section 7702.[9] The proceeds payable to the contract's owner upon the death of the insured are the death benefit, any dividend additions, any amount payable under an extra benefit rider, and a refund of unearned premium, reduced by any loan balance and unpaid premiums.

Policy Value -- The policy value under each COLI contract is determined by accumulating the net premiums paid (gross premiums reduced by any contractually specified loading charges),

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[6] The contract originally delivered to Taxpayer did not include the endorsement that applies partial withdrawals in the manner described. This memorandum assumes its inclusion as the parties have consistently acted as if the endorsements were included from the date of issue.

[7] Of the Number D insurance policies, Number E (with an annual premium of Amount J) covered the lives of employees who were "exempt," as defined by the Fair Labor Standards Act, and Number L (with an annual premium of Amount H) covered the lives of employees who were non-exempt.

[8] The illustrations assumed that the policies' benefits would be "paid up" after nine years so that no further premiums would be needed.

[9] Because of this formula, the COLI contracts will meet the definition of life insurance contracts under section 7702 if the applicable law requirement of section 7702(a) is satisfied.

plus any dividends applied to the policy value, and less the cost of insurance charges. The policy value is also reduced by any partial withdrawals. Each policy contains a Table of Values with minimum policy values based on the minimum guaranteed interest rate of four percent, the maximum guaranteed cost of insurance charges, and the policy's expense charges. This Table of Values reflects the increase in death benefits that will eventually occur if the annual premiums continue to be paid when due.

The policy value has several effects under Form F: (1) a policy value above the minimum tabular values may force a death benefit increase to assure compliance with the cash value accumulation test of section 7702 (under the formula assuring compliance of the contract with that section), (2) the policy value is the cash surrender value (amount distributed to the policyholder when a policy is surrendered prior to death) after reduction for outstanding loans (with accrued interest) and unpaid premiums, and (3) the policy value is the starting point for fixing the policy's loan limit.

Interest Credited -- Interest is credited to policy value at one of three different interest rates: the "Current Credited Unloaned Interest Rate" (the basic crediting rate) or one of two "Current Credited Loaned Interest Rates" (the two rates associated with borrowed policy value). The rate applied depends upon whether the policy value is in use as collateral for a loan from Insurer and, if so used, whether the loan carries a fixed or adjustable loan interest rate.

The basic crediting rate applies only to the portion of the policy value that is not used as collateral for a policy loan. The basic crediting rate is defined as the greater of (i) a rate that Insurer may declare or (ii) four percent per year. This rate has little application if the policyholder elects to make the maximum policy loans permissible within the limits of section 264.

The Current Credited Loaned Interest Rate credited to the policy value that collateralizes a policy loan carrying an adjustable rate (adjustable loan crediting rate) is the greater of:

(a) the ratio of (i) Moody's Corporate Bond Yield Average - Monthly Corporate Baa (the Baa rate)" for the calendar month two months before the date on which the rate is determined, and (ii) 100% less the average Baa rate defined in (i), and

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[10] The use of the Baa rate in Form F was considered to be a feature "unique" to COLI policies by the outside actuarial firm engaged by the Administrator to develop COLI products.

(b) the basic crediting rate, defined as the greater of (i) a rate that Insurer may declare, or (ii) four percent per year.

Because the Baa rate has been (and generally will be) in excess of both four percent and the basic crediting rate declared by Insurer, paragraph (a) effectively determines the adjustable loan crediting rate. This rate can be expressed in the formula:

$$\text{Adjustable loan crediting rate} = \frac{\text{Baa}}{1 - \text{Baa}}$$

For example, if the Baa rate is 10 percent, the adjustable loan crediting rate would be 11.1 percent (.10/(1-.10)).

Under a Form F endorsement attached to Taxpayer's COLI contracts, a policyholder can elect, but only at issue, to have the adjustable loan crediting rate increased through using a "T-factor." Using a T-factor increases the adjustable loan crediting rate (and thus the adjustable loan rate discussed below) to a rate higher than the formula detailed above. State I, where Insurer was domiciled, disapproved the use of this endorsement, on the grounds that:

> [I]t is inappropriate for a policyholder to determine within a range what these two rates [the loan and crediting rates] should be. The premise of the variable loan rate is to charge a rate dependent on an outside index, and the methodology used to determine the credited interest rate should rely on company expectation, not policyholder discretion.

Taxpayer did not, according to the material submitted, elect to apply a T-factor to increase the adjustable loan rate.

If the policy value secures a fixed rate policy loan, the interest credited to the policy value (the fixed loan crediting rate) is the greater of (i) a rate that Insurer may declare, or (ii) four percent per year. Although this definition is the same as for the policy value not used as collateral, the two crediting rates need not be the same. Further, although a basic crediting rate has been applied to the policy value that is not used as collateral from inception of the COLI contracts, no fixed loan crediting rate was declared by Insurer until Date K.

Other policy forms offered by Insurer at the time that Taxpayer purchased its COLI contracts also adjusted the crediting rate on policy values to assure a fixed, minimum spread between crediting and loan rates. In *none* of these other forms, did the crediting rate go above a common index, such as Moody's Corporate Bond Yield Average--Monthly Average Corporate rate (Moody's

Average Corporate rate), when the policy value was used to collateralize a policy loan.

Policv Charses -- There are no specified policy fees. However, expense charges (the loading charges) are imposed during the entire duration of each COLI contract. For a 31-year-old female, the loading charges, as a percentage of the Amount H or Amount J premium, are:

Policv Year	Loading Charge

The loading charges differ for each policy based upon the age and gender of the insured but are similar in pattern to the numbers listed above. In general, the loading charges are less than the numbers in the above table if the insured is older at issue. Both Taxpayer and the Revenue Agent have asked us to assume that the loading charges for a 31-year-old female are typical of the COLI contracts.

Cost of Insurance Charses -- The cost of insurance charges, i.e., the amount paid to Insurer as consideration for its risk that the insured might die during the period covered by the charge, are deducted from the policy value on each processing date. The maximum monthly cost of insurance rates are the 1980 CSO(A) Mortality Table with monthly curtate functions.

Surrenders[11] and Withdrawals -- All (or a portion) of the policy value, including any paid-up additions, may be withdrawn under the base policy. A withdrawal first reduces the loan balance to the new loan limit (computed by reference to the new lower policy value after the withdrawal), while the remainder is paid to the policyholder in cash. Each withdrawal reduces the death benefit on a dollar for dollar basis rather than reducing it proportionally, as would occur with a partial surrender of a policy. No adjustments to the premium are made upon withdrawals accompanied by reductions in death benefit.

Policv Loans -- Policy loans, on the sole security of the policy, are available under Form F as required by state law. The loans need not be repaid until the death of the insured or the surrender of the policy.

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[11] There is no specific provision permitting surrenders of part or all of the death benefit under the COLI contracts.

The contractually defined loan limit is (1) the policy value plus the dividend value (defined as the cash value for any dividend additions, plus any other dividend credits), both computed as of the next policy anniversary, less (2) all unpaid premiums plus interest at the loan rate on each such premium to the interest due date. Although the formula does not so state, the loan limit presumably takes into account previously issued loans.[12] Restated, the loan limit is the year-end unborrowed cash value, assuming premiums are timely paid.

The interest rate on all loans secured by the policy value, pre-existing or new, is chosen annually by the policyholder, who can select either an adjustable or a fixed loan rate. The adjustable loan rate (payable in arrears) is determined by Insurer annually two months before the start of the policy year and can be any rate that does not exceed the contractually specified maximum. The maximum[13] adjustable loan rate is the greater of:

(a) Moody's Average Corporate rate, as published by Moody's for the calendar month two months before the date on which the rate is determined, and

(b) the adjustable loan crediting rate (the interest rate credited on that portion of the policy value which is equal to the loan balance) plus one percent.

The adjustable loan crediting rate that is the base for the borrowing rate described by paragraph (b) is higher than the Baa rate which, in turn, is higher than the Moody's Average Corporate rate. Accordingly, the adjustable loan rate determined under paragraph (b) is always higher than the rate determined under paragraph (a). The adjustable loan rate under paragraph (b) can be described in a fraction that is closely related to the formula used for the underlying adjustable loan crediting rate:

$$\text{Adjustable Loan Rate} = \frac{\text{Baa}}{1 - \text{Baa}} + 1\%$$

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[12] Section 264(a)(4) disallows the interest on loans under any COLI contract that exceed $50,000 cumulatively, which serves as a practical cap on borrowing that is often lower than the contractual loan limit.

[13] Although Form F only defines a maximum adjustable loan rate, the rate declared by Insurer each year has never been less than the maximum.

If, using the earlier example, the Baa rate is 10 percent, the adjustable loan crediting rate is 11.1 percent, and the adjustable loan rate under paragraph (b) is 12.1 percent

At any time, the policyholder can also elect a fixed loan rate option of 8.0 percent (if charged in arrears) or 1.4 percent (if charged in advance). If the fixed loan rate is selected by the policyholder, the amount credited to the portion of the policy value that is collateral for the loan (the fixed loan crediting rate) is the greater of a rate declared by Insurer or four percent (the minimum interest rate guarantee). As the fixed loan rate has never been selected by Taxpayer, the fixed loan crediting rate has never applied to the portion of the policy value used as collateral for the COLI contract loans."

Each year, the statements provided to Taxpayer assumed that Taxpayer would select the higher adjustable loan rate. Although Taxpayer could have opted for the fixed loan rate at any time, the statements failed to specify the fixed loan crediting rate that would have allowed Taxpayer to determine whether the same one percent spread would apply. There is also no evidence that Taxpayer inquired about the fixed loan crediting rate. As noted earlier, Insurer did not declare a fixed loan crediting rate until Date K.

Dividends -- Form F, as endorsed, states that Insurer "will credit this policy with such dividends as we may apportion." Dividends may be paid in cash (applied against the premium due), applied to policy value, or used to purchase paid-up life insurance or one-year term insurance, at the option of the policyholder. Insurer credits dividends at the beginning of each policy year under Form F, including upon the issue date of the policy. The crediting of a dividend upon the issue date is not a benefit under life insurance contracts generally, and is not specified in the contract.

There are three components of the dividends paid under Form F, only two of which applied during the taxable years at issue. For example, the Year V Dividend Declaration provides that the dividends credited in Year V would be the sum of three items: (a) an excess interest dividend, (b) a mortality dividend, and (c) a loading dividend, reduced by deferred acquisition cost (DAC) reductions and increased by DAC amortization. The excess interest component of the dividend is zero until the end of the 15th policy year and, therefore, can be ignored for purposes of this memorandum.

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[14] Since Issuer first informed policyholders of these rates in Date K, the same one percent spread between borrowing and crediting rates has occurred under both the fixed and adjustable loan rate scenarios.

The second component was a mortality dividend that shifted any profit due to favorable mortality from Insurer to the purchasers of large COLI programs. The correspondence and memoranda contemporaneous to the issuance of the COLI contracts anticipated that Insurer's profit on Taxpayer's COLI program would be derived principally from the one percent interest spread between the crediting and borrowing rates related to the policy loans, rather than from excess mortality charges. However, the insureds covered under Form F contracts lived longer than anticipated. In Year V, Insurer enhanced the mortality element to the dividend calculation for Form F contracts at the behest of Form F policyholders, Taxpayer and others, who detailed concerns that they would not be obtaining the benefit of the original bargain if Insurer retained the full cost of insurance charges.

The third and most significant factor in the amount of the declared dividend was the loading dividend, which was derived from the excess of the loading charges specified in the contract over the actual expenses of administering the program. Through the application of seven different factors used in the determination of the portion of the loading charge to be returned, a major portion of the contractually specified loading charge is made available to the policyholder at the beginning of each policy year. For example, in the fourth year of Taxpayer's COLI program beginning on Policy Date, Year X, approximately 86 percent of the premium paid for that policy year was returned to Taxpayer as paid, or approximately 94 percent of the aggregate loading charges specified in the contracts. The dividends calculated under the COLI contracts corresponded closely to the original illustrations, with the exception of the modification of the mortality dividend.

Both Insurer and Taxpayer have treated the Number D COLI contracts as a unified program, and the Form F terms of the COLI contracts, including all endorsements, have been applied on an aggregate basis. All transactions, while taking into account variances implicit in having age and sex groupings of insureds, are accounted for on an aggregate basis.

The gross premiums due, in the aggregate for all outstanding COLI contracts at the beginning of each policy year, beginning on Policy Date, Year T, through the premiums due for the policy year beginning Policy Date, Year Z, were:

Policv Year	Premium"

The cost of insurance charges for the policy years beginning on Policy Date of each year were:

Policv Year	Cost of Insurance

The interest rates disclosed to Taxpayer for the first six policy years were as follows:

Policy Year	Basic Crediting Rate*	Adjustable Loan Creditins Rate	Adjustable Loan Rate

*Applies only to the unborrowed portion of policy value.

The corresponding Baa and Moody's Average Corporate rates from Month 1 of the previous calendar year (the months and rates used as the starting point for the interest rate calculations under the COLI contracts),[16] and the adjustable loan rates for each policy year were:

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[15] The periodic reports on the COLI contracts are inconsistent on whether gross premiums are reduced by deaths that have occurred but which have not been reported as of the date the premiums are due. The differences are not material and can be resolved between Taxpayer and the Revenue Agent.

[16] The use of the prior Month l's Baa rate is not in accordance with the terms of Form F as Month 1 is four months, rather than two months, prior to the COLI program anniversary. This discrepancy is unexplained.

Policy Year	Baa Rate	Moody's Average Corporates	Adjustable Loan Rate

The amount borrowed by Taxpayer during the first three policy years, using the COLI contracts' policy values as security, and the interest at the adjustable loan rate for those and succeeding years, are as follows:

Policy Year	New Borrowing	Interest Accrued

Dividends made available to Taxpayer on the first day of each policy year were:

Year	Loading Dividend	Mortality Dividend	Dividends as Percentage of Gross Premiums Due

The relationships of the loading charges, the loading dividends, and the aggregate premiums are as follows:[17]

[17] The aggregate numbers in this table are slightly less than would occur if all insureds were the same age and sex as under the representative policy used by Taxpayer and the Revenue Agent. This slight decrease in loading charges and loading dividends as percentages of the premiums occurs because some members of the group of insureds under the Taxpayer COLI program are male and/or older than the insured under the representative policy.

Policy Year	Loading Charge as Percent of Premium	Loading Dividend as a Percent of Loading Charge	Loading Dividend as a Percent of Premium Paid

Withdrawals of policy value began in the fourth policy year. The withdrawals, which Taxpayer represents were on a roughly pro rata basis among the COLI contracts, were in the following aggregate amounts:

Policy Year	Withdrawal

The components described above operated in a unified manner as contemplated in the illustrations prepared by the Insurance Agent during the study period prior to the purchase of the COLI contracts. The program also operated in accordance with the ongoing reports of the manner in which the COLI Plan operated, which showed substantial similarity to the illustrations. Taxpayer notes that there were deviations from the originally contemplated plan as to the interest rates (which were expected to fluctuate), the manner in which the dividends *were* applied under the contract, and the amounts withdrawn from each COLI contract's policy values. Nonetheless, the COLI program operated with only immaterial variations from the anticipated program -- Taxpayer borrowed in the first three years and used loading charge-derived dividends and withdrawals to minimize its costs in subsequent years.

With the assistance of the Administrator, the Insurance Agent sent periodic reports to Taxpayer detailing the results of the COLI program, providing a summary of amounts due for the upcoming year and an annual plan review. Specifically, Taxpayer was informed of the amount due, and (by age and gender groups) the prior loans, loan interest due, premiums due, amount of premiums borrowed (if any), net amount of premiums due, loans in excess of premiums (if any), and total loans as of the payment due date.

In the first three years, the statements set forth the total stated premiums for all COLI contracts still in force: (1) reduced by loans made against the policy values, (2) reduced by the loading dividends that were treated as paid to Taxpayer (rather than credited to policy values), and (3) increased (beginning at the end of the first policy year) by one year's accrued loan interest. The final net figure was the amount to be remitted to Insurer. During the first two policy years, all of the loading dividend was credited to policy value which maximized the amount that could be borrowed under the COLI contracts' terms. Beginning in the third policy year, the loading dividend credited at the beginning of the policy year was divided between application to the policy value and payment of the premium due. The remaining loading dividend and the revised mortality dividend" credited at the beginning of the third policy year were applied to pay the premium.

In the fourth through sixth policy years, Taxpayer withdrew large sums from the COLI contracts' policy values, and all dividends (loading and mortality) were credited against premiums due rather than applied to policy value. Accordingly, the statements detailed the gross premium due, increased by the accrued loan interest due, and reduced by dividends and partial withdrawals from the COLI contracts.

The following summarizes the amounts (with three zeros omitted) that were taken into account to determine the net amount to be remitted from Taxpayer to Insurer:

Policy Year	Gross+ Premium	Dividends Applied*	Policy Loans	Interest Due	Partial Withdrawals	Net Amount Remitted

\+ The number of COLI contracts dropped each year because of contracts that terminated when the individual insured died.
* These amounts are only the dividends treated as paid in cash to Taxpayer and do not include dividends credited to policy values.

After taking into account the dividends, the loan interest accrued, the policy values, and the partial withdrawals, the aggregate net cash surrender values remaining in the contracts were, at all times throughout the taxable years at issue, less than one percent of year end policy value, as shown below:[19]

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[18] The enhancement of the mortality component of the dividend in response to the favorable experience is one of the few differences between the contracts as administered and as illustrated before issuance.

[19] Although the policy values (and death benefits) would have increased over time had Taxpayer continued to pay premiums beyond the first seven to ten years of the policy, the

Policy Year	Year End Policy Value*	Policy Loan Balance*	Accrued Unpaid Interest On Policy Loans*	Net Year End Policy Surrender Value*

*All values are actual dollar values; no zeros are omitted.

Taxpayer expected the COLI program to improve Taxpayer's profit and loss for financial reporting purposes, taking into account the tax effects of the borrowing. Although the results have not been exactly as anticipated, Taxpayer represents that the effects were generally as predicted by the illustrations. Taxpayer claims that the COLI program had a positive effect on its financial statement because the death benefits received and interest and dividends credited are treated as profit and policy values (net of policy loans) are treated as an asset, although interest on the policy loans and premiums paid largely offset these benefits. The policy loans are not listed as liabilities on Taxpayer's financial statements.

For federal tax purposes, the annual increases in the policy values under the policies that are reported as income in the financial statements are eliminated from taxable income on Schedule M of Taxpayer's income tax return. Death benefits are also eliminated from taxable income on Schedule M. Similarly, premiums charged on the policies were recorded as expenses on Taxpayer's financial statements but reversed on Schedule M and not claimed as deductions from taxable income. Finally, the interest amounts charged to Taxpayer on policy loans were treated as expenses for financial statement purposes and claimed as deductions against taxable income on Taxpayer's return.

Applicable Law and Rationale

(1) Whether the amounts claimed **by** Taxpayer as deductions are interest **paid or accrued during the taxable year on indebtedness within the meaning of section 163.**

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illustrations anticipated that Taxpayer would elect paid-up status and stop paying premiums before the policy values grew to any appreciable extent.

Section 163 allows as a deduction all interest paid or accrued within the taxable year on indebtedness. However, a prerequisite to the allowance of any interest deduction is that the underlying transaction must have economic substance apart from its tax benefits. In Knetsch v. United States, 364 U.S. 361 (1960), the Supreme Court applied the economic substance doctrine to disallow an interest deduction where it found that "there was nothing of substance to be realized . . . from [the] transaction beyond a tax deduction." 364 U.S. at 366. The Court held that, because the taxpayer's financing arrangement with an insurance company lacked non-tax substance, the transaction did not create a valid indebtedness for purposes of Federal tax law.

(a) Whether Taxpayer, in substance, incurred an "indebtedness" for Federal tax purposes.

The Field contends that Taxpayer's financing transaction with Insurer is not valid "indebtedness" for tax purposes because Taxpayer did not, in substance, acquire the use of funds it otherwise would not have had, and Insurer did not part with the use of funds from which it otherwise would have derived a benefit. See Golsen v. Commissioner, 54 T.C. 742 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971) (collectively Golsen I). See also Goldman v. United States, 403 F.2d 776 (10th Cir. 1968). Although Taxpayer, in form, obtained the use of money from Insurer to pay premiums on the COLI policies, the totality of the facts and circumstances indicate that Insurer did not part with any funds through loans and did not acquire the use of any funds through receipt of premiums. While Taxpayer and Insurer arranged for an appearance of cash transfers that flowed in both directions, a substantial portion of the amounts paid were returned concurrently with their payment, creating a circular cash flow.

The Field further contends that the circular cash flow was facilitated and enhanced by the COLI policies' high premiums. According to the Field, an analysis of the premiums paid for the policies, and the insurance benefits and cash surrender values produced thereby, demonstrates that the premiums were intended to pay neither for current insurance coverage nor future benefits. Rather, a substantial portion of the premiums were paid for the purpose of either being borrowed or funding simultaneous dividends and partial withdrawals.

During the first three years of the COLI policies, purported policy loans were the primary mechanism used to produce the circular cash flow. After policy year three, the loading charges stipulated in the COLI policies increased substantially, thereby providing a source from which Insurer could "pay" loading dividends that effectively offset a major part of the premiums "due" under the COLI contracts. This relationship is demonstrated in the earlier table showing the relationship each year between contractually specified loading charge, loading dividend, and premiums due.

Insurer informed Taxpayer each year of the amount of the loading dividend payable at the beginning of that year when the premium also was due. The loading dividend had the effect of returning to Taxpayer a substantial portion of the premium simultaneously with its payment. For example, in the fifth policy year, 92 percent of the loading charge (which was 94 percent of the premium for that year) was returned to Taxpayer as a loading dividend that "paid" approximately 86 percent of the premium. In addition, beginning in policy year four, amounts previously credited to Taxpayer's policy value account were withdrawn by Taxpayer from policy value and credited against premiums and interest payments due.

The Field contends that the loading dividends were not true dividends because they were dependent neither upon the experience of the Insurer nor upon the Insurer's discretion. The Field argues that the guaranteed aspect of the loading dividends is demonstrated by the total improbability of their not being declared. If substantial dividends were not declared in advance of the policies' anniversary date when the premiums became due, Taxpayer simply could refuse to pay the premium and elect to have the policy lapse or convert to reduced paid-up status (in either event the outstanding debt could be paid off without further cash outlay by Taxpayer).

The Field also points to correspondence and memoranda in the possession of Taxpayer and the Insurance Agent making clear that the loading dividend was an important part of the COLI program. With the assurances previously given by Insurer, the Insurance Agent would be in a position to reassure Taxpayer as to any concerns about this issue.,

With regard to the partial withdrawals from the COLI policies, the ability to make partial withdrawals of policy value is not usual on a fixed premium life insurance contract. Ordinarily, a withdrawal would be treated as a partial surrender that would reduce the death benefit proportionally. Further, a withdrawal of cash value that does not affect the future premiums due is also unusual with a fixed annual premium contract.

Taxpayer contests the contention that the premiums for its COLI policies were artificially high. Taxpayer argues that any inquiry into the size and structure of the premiums must begin and end with the testing of the contracts under sections 7702 (defining "life insurance contract" for federal tax purposes) and 7702A (establishing a specific limitation on the level of life insurance premiums in relation to death benefits). Taxpayer contends that, since the COLI policies are life insurance contracts under section 7702 and the premiums for the policies do not exceed the limits imposed by section 7702A, the premiums on its COLI policies cannot, by definition, be artificially high under the standards established by Congress for life insurance.

Taxpayer states that Insurer designed the COLI policy form, secured regulatory approval by multiple states, and offered it on a non-negotiable basis to Taxpayer as well as to other prospective corporate purchasers. Taxpayer contends that the COLI policies' loading charges provided Insurer with a cushion against expenses of administration. In addition, Taxpayer argues that using a loading dividend has certain unspecified advantages over using net premiums for State premium tax purposes. Taxpayer also does not agree that the loading dividends were contractually guaranteed or virtually assured. Rather, Taxpayer contends that Insurer's Board of Directors independently determined each year whether to pay dividends after taking into account the characteristics of the COLI programs, including the large premiums being paid in the aggregate by the purchasers of the COLI policies and the inequity to those policyholders of holding large surplus generated by those premiums for a full year before distributing it.

Taxpayer argues its situation is distinguishable from the facts of Knetsch, which involved borrowing nearly all the cash value of an annuity contract. Borrowing an annuity contract's entire cash value defeats the purpose of the contract -- that is, the eventual production of annuity payments. Knetsch's transaction with the insurance company, therefore, did not appreciably affect his beneficial interest except to reduce his tax; that is, Knetsch realized nothing from the transaction beyond a tax deduction. See 364 U.S. at 366. In contrast, Taxpayer claims that its COLI policies always provide a substantial amount of death benefit protection in excess of policy loans. Taxpayer argues that Knetsch does not apply to its leveraged COLI policies because the substantial life insurance protection provided by those policies ensures that the policies have economic substance appreciably affecting Taxpayer's beneficial interest beyond the realization of a tax deduction.

Taxpayer also contends that the "four out of seven" test in section 264(c)(1) explicitly permits the first three premiums of a life insurance contract to be paid by means of policy loans, provided the next four premiums for the contract are paid by other means (for example, policyholder dividends or partial withdrawals). Taxpayer argues that the Field's circular cash flow argument is not consistent with either the statute or published Service position. See Rev. Rul. 71-309, 1971-2 C.B. 168 (section 264(c) satisfied where corporate purchaser and transferee trust cumulatively borrowed in no more than three of first seven years); Rev. Rul. 72-609, 1972-2 C.B. 199 (borrowing as to more than three of first seven years violates section 264(a)(3)).

With regard to the Golsen I case, which disallowed a deduction for interest on indebtedness incurred to purchase a life insurance contract, Taxpayer points out that in Woodson-Tenent Laboratories, Inc. v. United States, 454 F.2d 637 (6th Cir. 1972). the Court of Appeals rejected the Government's contention that Woodson-Tenent's leveraged life insurance program on key employees lacked economic substance, expressed its disagreement with the Golsen I decision, and allowed a deduction for interest on policy loans used to purchase the life insurance coverage. See also Campbell v. Cen-Tex. Inc., 377 F2d 688 (5th Cir. 1967) (hereafter Cen-Tex) and Priester Machinery Co. V. United States, 296 F. Supp. 604 (W.D. Tenn. 1969).

Taxpayer also contends that its situation is factually distinguishable from Golsen I and other cases that have disallowed deductions for interest on life insurance policy loans used to pay premiums. Those cases involved borrowing to prepay premiums. In contrast, Taxpayer limited its borrowing to the amount needed to pay each of the first three level annual premiums as each premium became due.[20] See Golsen v United States, 1980-2 U.S.T.C. para. 9741 (Ct. Cl. 1980) (upholding deduction for interest on indebtedness incurred to pay currently due premiums) (referred to hereafter as Golsen II).[21]

Taxpayer notes that both Treasury testimony and Treasury Reports have discussed broad-based leveraged COLI programs and acknowledged the tax benefit flowing from the interest deductions under those programs. Statement of Dennis E. Ross, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, Hearings Before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives 32-33 (Mar. 15, 1988); Statement of Kenneth W. Gideon, Assistant Secretary (Tax Policy), Department of the Treasury, Hearings Before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives 42-43 (Feb. 21, 1990); Department of Treasury, Report to The Consress on the Taxation of Life Insurance Products (Mar. 1990).

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[20] See discussion below of the definition of "annual premiums due" in comparison to the stated premiums.

[21] This case involved the same taxpayer and life insurance policies as Golsen I, but different tax years. The Claims Court in Golsen II did not view the earlier decision as controlling with respect to interest on loans made after Golsen had eliminated the prepaid premium fund.

Taxpayer also points out that section 264(a)(3) was amended in 1996 by section 501 of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), 1996-43 I.R.B. 7, 60, to deny interest deductions generated by broad-based leveraged COLI programs. In enacting the 1996 changes to section 264, however, Congress granted transition relief whereby the deduction for otherwise allowable interest incurred under then existing COLI programs is phased out over several years. Taxpayer argues that the transition relief manifests Congressional recognition that the broad-based leveraged COLI programs involved valid indebtedness for tax purposes for years prior to 1996 (including the years at issue), and further contends that its leveraged COLI program is eligible for the transition relief.

We agree with the Field. Even if Taxpayer's COLI policies are life insurance contracts other than modified endowment contracts under sections 7702 and 7702A, such qualification does not preclude a finding that the premiums are artificially high in the context of determining whether Taxpayer's financing arrangement has economic substance. Taxpayer claims that it borrowed from Insurer to finance the payment of insurance premiums. Contrary to Taxpayer's stated purpose for borrowing, however, a substantial portion of the premiums paid for these contracts did not pay for insurance benefits; instead, they were paid for the purpose of either being borrowed or funding simultaneous dividends or partial withdrawals. The policies' high loading charges and loading dividends were specifically designed for the large employer COLI market where the loading costs were de minimis. Thus, the high premium structure together with loading dividend and partial withdrawal mechanisms served no economic purpose other than to provide the circular flow of cash necessary to produce the expected tax benefits with a minimum cash outlay by Taxpayer.

Furthermore, compliance with the literal requirements of section 264 does not preclude the Service from looking below the surface to examine whether there is real indebtedness for federal tax purposes. Settled law makes clear that section 264 only concerns actual interest on real indebtedness, i.e., interest on policy loans that have economic substance for tax purposes. In Knetsch, supra, the Supreme Court rejected the taxpayer's argument that Congress, by amending section 264 effective for transactions occurring after the taxpayer's, implicitly approved the taxpayer's claimed interest deductions. The Court held that the 1954 amendment was intended to further Congress' policy to disallow interest incurred to produce partially exempt income and was not intended to address sham transactions. The Court held that the taxpayer's problem was caused by his noncompliance with section 163 and not section 264, which is directed at transactions involving interest payments on actual indebtedness. In Golsen I, suora, the Tax Court rejected an argument similar to that made by Taxpayer here, stating that "[section 2641 simply denies, or disallows, or prohibits deductions that might otherwise be allowable . . [and] does not confer the right to any deduction ...." 54 T.C. at 755-756. The Tenth Circuit affirmed the Tax Court in Golsen I, finding "[t]he fact that Congress considered it expedient to remedy an avoidance device which had at least some court recognition does not bind us in dealing with a specific fact situation." 445 F.2d at 990.

We do not interpret the cases and rulings cited by Taxpayer to hold that all purported policy loans used to pay currently due premiums are per se indebtedness for purposes of section 163 or that interest on such policy loans is deductible so long as section 264 parameters are satisfied. The legislative history for the most recent modification to section 264 in 1996 makes clear that the opposite is true:

> Provided the transaction gives rise to debt for Federal income tax purposes, and provided the 4-out-of-7 rule is met,[22] a company may borrow up to $50,000 per employee, officer, or financially interested person, and is not precluded under section 264 from deducting the interest on the debt, even though the earnings inside the life insurance contract (inside buildup) are tax-free, and in fact the taxpayer has full use of the borrowed funds.

H.R. Conf. Rep. 736, 104th Cong., 2d Sess. 319-320 (1996) (1996 Conference Report). In addition, Congress stated that no inference was intended as to the treatment of interest paid or accrued under prior law. Id. at 322. The transaction must give rise to indebtedness under general tax law principles, taking into account the facts and circumstances.

The effect of the transition rule provided in connection with the 1996 amendment to section 264 is that interest under some broad-based leveraged COLI programs, if previously deductible under general tax law principles, continues to be partially deductible during the phaseout of the deduction. However, there is no statement, direct or indirect, that suggests that all broad-based leveraged COLI programs involved genuine indebtedness.

In this case, the loading dividend mechanism, partial withdrawals, and artificial premium structure of Taxpayer's COLI

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[22] [footnote 23 in Conference Report] Interest deductions are disallowed if any of the disallowance rules of section 264(a)(2)-(4) apply. The disallowance rule of section 264(a)(3) is not applicable if one of the exceptions of section 264(c), such as the 4-out-of-7 rule (sec. 264(c)(1)) is satisfied. In addition to the specific disallowance rules of section 264, generally applicable principles of tax law apply.

policies served no economic purpose other than to provide the circular flow of cash necessary to produce the expected tax benefits with a minimum cash outlay by Taxpayer. These features distinguish Taxpayer's leveraged COLI from cases and rulings cited by Taxpayer. Accordingly, those cases and rulings are not dispositive of the issue of whether Taxpayer's transaction produced genuine indebtedness.

"Indebtedness" has been defined as "an unconditional and legally enforceable obligation for the payment of money." Autenreith v. Commissioner, 115 F.2d 856, 858 (3d Cir. 1940). In order to be deductible, interest must be paid on genuine indebtedness, that is, indebtedness in substance and not merely in form. Knetsch, 364 U.S. at 365. For an indebtedness to exist in substance, the borrower must obtain the use of funds which he would not otherwise have enjoyed, and the lender must part with the use of funds from which it would have otherwise derived a benefit. See Golsen I; see also Rev. Rul 54-94, 1954-1 C.B. 53. Enforceability of a debt under state law does not necessarily mean that it is an "indebtedness" for Federal tax purposes. Peerless Industries v. United States, 94-1 U.S.T.C. ¶ 50,043 (E.D. Pa. 1994), aff'd in an unpublished ooinion, 37 F.3d 1488 (3d Cir. 1994).

As Taxpayer did not acquire, and Insurer did not forgo, the use of any funds as a result of the loans, the Field correctly determined that the purported policy loans in this case did not produce "indebtedness" for tax purposes.

(b) Whether Taxpayer, in substance, paid or accrued "interest" for Federal tax purposes.

The Field also contends that the amounts paid by Taxpayer and denominated as "interest" by the parties do not, in substance, represent compensation for the use or forbearance of money. A number of arguments are made to support this conclusion.

The first is that, as discussed above, Taxpayer did not obtain and Insurer did not forgo the use of funds so that there is no "indebtedness."

In addition, the Field contends that the parties' characterization of certain amounts as "interest" disregards both the manner in which the amounts are determined and the person with the power to determine the rate to be paid. The amounts do not represent a charge determined by Insurer (as lender), based upon its judgment about overall market interest rates and the particular characteristics of a policy loan secured by policy value. Instead, the "interest" rate is effectively controlled by Taxpayer and unrelated to the underlying risk.

To support its contention, the Field points out that the formula used to derive the adjustable loan rate under Form F, designed for large corporate purchasers, produces a rate substantially higher than the interest rates under other life insurance policies available to less creditworthy purchasers. Further, unlike a typical insurance policy loan, the policy loan rate is changeable annually at the option of the policyholder.

Although the borrowing rate on a policy loan and the crediting rate for policy value securing that loan are often linked (a process called "direct reflection"), the rate chosen as the base generally bears some relationship to the insurance company's investment practices by being keyed to a general commercial rate -- in most cases, the Moody's Average Corporate rate. Because the structure of Form F's borrowing and crediting rates produced a one percent profit spread regardless of the rate chosen, Insurer was indifferent to the level of the adjustable loan interest rate charged, a factor not present in most lending transactions, although common with policy loans.

The Field contends that the lack of an "interest" character is further demonstrated by Taxpayer's choice of the higher of the two available loan interest rates for each year of the program. Taxpayer had the option, exercisable annually, to borrow at a fixed or adjustable loan interest rate that would apply to all outstanding loans, as well as to that year's loans, for all future policy years until changed by Taxpayer. Taxpayer knew both the fixed and adjustable borrowing rates before making its annual decision about which interest rate would apply. For each year of the program, the adjustable loan rate was substantially greater than the fixed loan rate. Although choosing the fixed loan rate would allow Taxpayer to borrow at a significantly reduced cost, Taxpayer nonetheless always chose the higher adjustable loan rate.

Taxpayer contends that choosing the higher adjustable loan rate made economic sense because this choice guaranteed that its borrowing costs were capped at the one percent spread between the adjustable loan and crediting rates. Taxpayer also claims that the interest rates on its COLI policy loans were well within the range of commercial market rates for loans and that the policy loan rates correlate reasonably well to its average interest expense for short-term borrowing. Taxpayer points out that the policy loan interest rate, in some years, is less than the interest rate applicable to large taxpayers' tax underpayments under section 6621(c). Taxpayer further claims that the policy loan interest rates were in the range of the short-term rate under section 482 for respecting loans between related parties.

In rebuttal, the Field argues that both Taxpayer and Insurer understood that the fixed loan rate would not be elected regardless of net cost. There is no evidence that Taxpayer inquired about the fixed loan crediting rate in any year. In later years, when Insurer did declare a crediting rate applicable to policies with fixed rate loans, the spread between the crediting rate and the interest rate for fixed rate loans was the same one percent charged on adjustable rate loans. Nevertheless, Taxpayer chose the higher rate because it improved the after-tax returns on the program by increasing the claimed interest deduction and the amount credited to the COLI policies' tax deferred inside buildup.

"Interest" is compensation paid for the use or forbearance of money. See, e.g., Old Colonv R.R. Co. v. Commissioner, 284 U.S. 552 (1932); Deputy v. DuPont, 308 U.S. 488 (1940). Interest is the charge per unit of time for the use of borrowed money. Thomoson v. Commissioner, 73 T.C. 878, 887 (1980). In short, interest is the equivalent of "rent" for the use of funds. Dickman v. Commissioner, 465 U.S. 330, 337 (1984). This is a defining feature of interest."

No deduction for interest is allowed where a taxpayer does not, in substance, pay an amount for the use of borrowed money. Knetsch, suora, 364 U.S. at 365; Golsen I, 54 T.C. at 753; Rev. Rul. 54-94, supra. In determining whether a payment constitutes interest on indebtedness, economic realities govern over the form in which a transaction is cast; labels are not determinative. Amounts that are compensation for the use or forbearance of money are treated as interest regardless of how the parties designate the amounts. See, e.g., Rev. Rul. 69-188, 1969-1 C.B. 54 (loan processing fee (points)); Rev. Rul. 69-290, 1969-1 C.B. 55 (amount paid for privilege of being granted a loan); L-R Heat Treatinq Co. v. Commissioner, 28 T.C. 894, 897 (1957) (bonus or premium paid by borrower to obtain loan). Conversely, amounts that are not compensation for the use or forbearance of money are not treated as interest even if the amounts are designated as "interest" by the parties. See, e.g., LaCroix v. Commissioner, 61 T.C. 471 (1974) (purported interest payment treated as a deposit or down payment on principal due); Rev. Rul. 69-189, 1969-1 C.B. 55 (statement by lender that entire loan charge is interest not sufficient if facts indicate that a portion of the charge is attributable to services performed in connection with the borrower's account).

We conclude that, based on the facts and circumstances described, the amounts denominated as "interest" by Taxpayer and Insurer did not, in substance, represent compensation for the use or forbearance of money. Instead, the amounts denominated as

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[23] A second defining feature of interest, i.e., the need to compensate the creditor for the risk of nonpayment associated with the debtor, is generally not present in an insurance policy loan context because the loan is fully secured by policy value.

"interest" were paid to support an interdependent and circular structure of charges and credits, the purpose of which was to increase Taxpayer's tax deductions (while simultaneously increasing the amounts credited to the COLI policies' tax deferred inside buildup).

(c) Whether Taxpayer possessed a non-tax, business purpose fox the financing transaction used to acquire the COLI contracts.

Taxpayer contends that it had several non-tax business reasons for engaging in the COLI program. First, Taxpayer contends that the economics of the COLI policies per se imbues the purchaser with a legitimate business justification for their purchase. That is, Taxpayer claims that it is inherently a legitimate transaction for a business to purchase life insurance policies that provide appreciable net death benefits or that can be reasonably expected to produce a pre-tax gain over the duration of the insurance program. Taxpayer claims that its COLI policies have these characteristics.

In addition, Taxpayer claims that it entered into the COLI program to finance unfunded employee benefit obligations. Taxpayer argues that in Cen-Tex, 377 F.2d at 692, the Fifth Circuit explicitly endorsed the leveraged purchase of life insurance to finance deferred compensation, and that the Sixth Circuit in Woodson-Tenent Laboratories adopted that conclusion.

The Field contends that Taxpayer's COLI financing arrangement did not have a non-tax purpose but rather was motivated by the tax benefits to be derived from deductions for interest paired with tax-deferred inside buildup under the COLI policies. Several arguments are made to support this contention

The Field contends that documents prepared contemporaneously with Taxpayer's COLI transaction, and correspondence between the Insurance Agent and Insurer as to policies issued on Form F generally, demonstrate that Taxpayer's overriding motivation in entering into the financing arrangement was its desire to obtain the maximum tax benefit from the deductibility of interest and accompanying tax-deferred inside buildup, and hence the highest possible after-tax return. The documents fail to link Taxpayer's stated purpose for purchasing the plan (that is, to finance employee benefits) and the benefits anticipated from the COLI program. Although Taxpayer was aware of its large liabilities for employee benefits, no specific health care commitments are identified nor is any explanation made as to how any health care commitments would be "funded" by the program.

The Field also argues that no rational relationship exists between the financing of unfunded employee benefits and Taxpayer's COLI program. Absent tax benefits due to interest deductions, the "additional profits" that Taxpayer claims its COLI program produced are illusory. The "profits" exist only if the costs associated with producing those amounts, primarily the COLI loans, are disregarded. Taxpayer's contemporaneous financial projections indicate that Taxpayer would transfer more cash to Insurer yearly than it would receive from Insurer. Taxpayer also knew that if it chose to cancel the COLI Plan, the policy value payable to Taxpayer after repayment of its COLI loans would always be significantly less than the actual cash paid to Insurer. Accordingly, the Field contends that Taxpayer could not have reasonably expected the cash flowing to it, even including death benefits, to correspond to employee benefits costs incurred at the time of the employee's death. Nor could Taxpayer have reasonably expected the policy values (including dividends and interest credited thereto), after taking into account the loans and the cost of the policy loans, to produce positive financial results.

In addition, the Field points out that the proceeds from the COLI program were not earmarked in any way for the provision of employee benefits. There is also nothing to indicate how the apparently arbitrary Amount H or Amount J premium used for each insured employee relates to, or was established to account for, Taxpayer's purported need to secure death benefits sufficient to finance employee benefits. Other features, such as large early year policy values, are discussed as desirable for their improvement on COLI policies' rates of return, but without explanation as to how these values would better match the COLI program gains to the costs of anticipated employee benefits. Instead, Taxpayer's Assistant Treasurer summed up the operation of the program as follows: "The economics of the program are essentially generated by the fact that we get tax relief on the interest expense associated with borrowing against the cash value of the policies, while the investment return built up within the policies and paid out to [Taxpayer] as death benefits are received as tax-free income."

The Field also contends that Taxpayer did not need to borrow from Insurer to accomplish the purchase of insurance benefits. For the first five years of the plan, Insurer charged Taxpayer total premiums of $143 million, which amount was approximately 25 times Insurer's cost of providing insurance (the mortality charge). Despite the magnitude of the stated premiums due, Insurer required Taxpayer to pay only slightly less than $18 million in cash annually in the first five years towards these charges; the balance of the premiums due was satisfied by the circular flows related to loans, dividends, and withdrawals. Similarly, although Insurer charged Taxpayer $150 million in interest during the first five years of the program, Taxpayer paid only $77 million in cash toward these charges. The Field contends that the parties anticipated from the beginning that Taxpayer would never be required to pay the bulk of the purported premium and interest charges other than by means of the circular cash flow devices. As Insurer was never going to require any more cash to support the insurance benefits than the net amounts from Taxpayer as originally illustrated, Taxpayer's borrowing served no non-tax purpose. In fact, the cash Taxpayer paid to Insurer approximated Insurer's cost of insurance, expenses, and profit; this is indicative of the true substance of the transaction, i.e., the payment of nondeductible premiums. See Golsen I, sunra, 54 T.C. at 753 (holding that the net cash that the insured paid to the insurance company was the true cost of the insurance purchased).

The Field also points to Taxpayer's indifference to the program's projected pre-tax losses. The Insurance Agent provided Taxpayer with several projections of the anticipated performance of the COLI program Taxpayer was considering for purchase. All of the projections showed that the COLI program would generate pre-tax losses and after-tax gains for at least the first forty years of the program. There is no indication in Taxpayer's correspondence with Insurance Agent, nor in Taxpayer's internal memoranda, that Taxpayer was concerned about the pre-tax loss aspect of the projections.

In rebuttal, Taxpayer argues that the Field's approach effectively requires the purchase of term insurance rather than whole life insurance coverage. Taxpayer argues that its borrowing made possible the many benefits associated with whole life coverage.

Additionally, Taxpayer contends that the Field's focus on the tax effects of the borrowing component of the overall transaction is misguided. Specifically, Taxpayer believes that a leveraged purchaser should be in the same economic position after tax as a purchaser who uses working capital. A taxpayer who purchases a life insurance contract using working capital reduces its taxable income by the income that would otherwise have been earned on the assets consumed in the purchase. In contrast, a taxpayer that uses borrowed funds to purchase a life insurance contract continues to receive the income generated by its working capital but incurs an interest expense with regard to the borrowed funds. Taxpayer argues that, absent a statutory disallowance provision, a leveraged purchaser of a life insurance contract should receive a tax benefit from the reduction of its taxable income by the amount of interest paid. Otherwise, the taxpayer who borrows is taxed more heavily than the taxpayer that uses its working capital.

We agree with the Field that the interest is not deductible under section 163. A transaction is recognized for tax purposes only if there is some non-tax purpose for the entire transaction. See Sheldon v. Commissioner, 94 T.C. 738, 759 (1990). The key to this determination is ascertaining whether the transaction is rationally related to a substantial non-tax purpose, considered objectively in light of the taxpayer's economic situation and intentions. Both the purpose and the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry. Cherin v. Commissioner, 89 T.C. 986, 993-994 (1987). This required relationship between purpose and means ordinarily will not be found unless there was a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs. See Yosha v. Commissioner, 861 F.2d 494, 498 (7th Cir. 1988).

In Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), cert. denied, 385 U.S. 1005 (1967), the transactions were real and conducted at arm's length, the taxpayer's indebtedness was enforceable with full recourse, and her investments were exposed to market risk. Nonetheless, the court held that the taxpayer's loan arrangement did not reflect a non-tax purpose when the taxpayer borrowed at four percent in order to purchase property that returned less than two percent and held no prospect of appreciation sufficient to counter the interest rate differential. Because the transaction had no non-tax substance, purpose, or utility, the court disallowed the claimed interest deductions. Accord, Rev. Rul. 81-149, 1981-l C.B. 77 (no interest deduction allowed for loan arrangement where taxpayer was required to deposit funds with lender to obtain loan, indicating that taxpayer had no need to borrow funds but entered into transaction solely for the tax benefits).

Similarly, in Sheldon, supra, the Tax Court stated that the potential for gain was not the sole standard by which it would judge the economic substance of the transaction, particularly where the potential for gain is "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions." Sheldon at 768.

Recently, in ACM Partnership v. Commissioner, T.C. Memo. 1997-115, the Tax Court disallowed a capital loss claimed by Colgate, a partner in ACM, based on its finding that the transaction lacked economic substance. The transaction involved an investment strategy motivated by tax considerations, but which Colgate asserted was imbued with non-tax considerations. Colgate claimed that the transaction had two non-tax purposes: to provide an investment return and to operate as a hedge. As to the investment aspect, Colgate claimed that certain notes purchased by ACM offered the partners a reasonable return on investment pending the occurrence of other steps of the transaction. However, the court found that there was no profit potential because of the large transaction costs. The court also dismissed Colgate's claim that the hedging aspect of the transaction was rationally related to any non-tax purpose because neither Colgate nor the other partners needed a hedge inside the partnership as they were all effectively hedged outside the partnership. The court held that Colgate's actions were not consistent with rational economic behavior but were based on the tax losses generated by the investment strategy. The court disallowed the claimed losses because the transaction served no non-tax purpose and therefore lacked substance.

In Golsen I, the Tenth Circuit held that insurance policy loans that lack economic substance will not be recognized for tax purposes notwithstanding the taxpayer's actual purchase of valuable insurance benefits. The court found that the loan transactions "superimposed" on the insurance transaction lacked substance and therefore did not produce interest deductible under section 163. 445 F.2d at 989. Accord, Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976) (no part of nonrecourse financing is treated as genuine indebtedness if, at the time of the acquisition of real property, the principal amount of the debt greatly exceeds the fair market value of the property securing the debt).

The memoranda and other documents prepared prior to, contemporaneously with, and after Taxpayer purchased the COLI Plan focus heavily on the tax benefits associated with the loan arrangement. By comparison, they contain relatively little discussion of how Taxpayer's COLI Plan was going to facilitate the financing of employee benefits. There is not a single contemporaneously prepared document drawing a connection, on an aggregate,. average, or individual basis, between the death benefits expected to be received from the COLI program and Taxpayer's stated employee benefit objectives. Finally, Taxpayer entered into the transaction despite the substantial pre-tax losses shown in the projections it relied upon in entering into the transaction.

Accordingly, based on all the facts and circumstances, we agree with the Field's determination that Taxpayer did not have a sufficient non-tax business purpose for the financing transaction used to acquire the COLI policies.

(2) Whether the relationship **of the debt to the annual premiums due fails to satisfy the "4 out of 7" test of section 264(c) (1)** and the interest **on the debt is disallowed under section 264(a)(3).**

Although we have concluded that the interest deductions should be disallowed as lacking economic substance, the Field also asked whether Taxpayer's transaction meets the "4 out of 7" exception of section 264(c)(1) to the general disallowance rule of section 264(a)(3). For purposes of this discussion only, we shall assume arguendo that Taxpayer's COLI program gave rise to genuine indebtedness and interest for federal tax purposes as section 264 would not apply otherwise.

Section 264(a) (3) provides that, except as provided in section 264(c), no deduction shall be allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life insurance contract (other than a single premium contract) 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 contract. Section 264(c) (1) states that section 264(a) (3) shall not apply "if no part of 4 of the annual premiums due during the ?-year period (beginning with the date the first premium on the contract to which such plan relates was paid) is paid under such plan by means of indebtedness."

In this case, the annual premium specified for each of Taxpayer's COLI policies was either Amount H or Amount J. If the "annual premiums due" for section 264(c) (1) purposes during each of the first seven years refers to each policy's specified Amount H or Amount J annual premium, then Taxpayer's borrowing would fall within the exception provided by section 264(c) (1). Accordingly, the question to be resolved is whether the "annual premiums due" in section 264(c) (1) refers to the gross annual premiums specified in each COLI policy.

The issue presented by the Field is whether the "annual premiums due" for purposes of section 264(c) (1) are the Amount H or Amount J annual premiums on the specifications page of each policy or whether the apparent premiums are to be reduced by the loading dividends that were intended to be, and were, taken into account as offsets on the billing statement at the beginning of each policy year. That is, do the annual premiums on Taxpayer's COLI policies exclude the loading dividends. A high percentage of each premium is allocable under Form F to "loading charges" in policy years four through seven -- an amount known to be in excess of the anticipated costs. The loading charge ensured that Insurer always had funds dedicated to the payment of the loading dividends. Beginning in policy year four, Taxpayer on the first day of the policy year was credited with dividends sufficient to offset the COLI policies' gross premiums almost in their entirety. The Field contends that Taxpayer never expected to pay, and Insurer never expected to receive, the premium nominally stated in the policy. Rather, Taxpayer expected to pay essentially only the cost of insurance charges and the one percent differential between the borrowing and crediting rates.

Taxpayer contends that, as a matter of law, the "4 out of 7" rule under section 264(c) (1) is applied using the "4 annual premiums due during the [initial] ?-year period." Taxpayer points out that the regulation implementing the 4 out of 7 rule, section 1.264-4(d) (1) (i) of the Income Tax Regulations, is framed in terms of "annual premiums due . . beginning with the first premium on the contract," that subsection (ii) of these regulations refers to "the stated annual premiums due," and that subsection (iv) refers to an "annual gross premium." Taxpayer claims that Congress was aware that policyholder dividends could affect the economics of leveraged life insurance purchases but did not intend for such dividends be taken into account when applying the "4 out of 7" rule. As support for this claim, Taxpayer cites an example in the 1963 Bluebook describing then current bank loan insurance or minimum deposit insurance plans. See Joint Committee on Taxation Staff, Staff Description of H.R. 8363. The Revenue Act of 1963. as Passed bv the U.S. House of Representatives, 88th Cong., 1st Sess. 61 (1963 Bluebook).

We do not find Taxpayer's arguments to be persuasive in view of the particular facts and circumstances of this case. The loading dividends received by Taxpayer are materially different from the dividends in the example in the legislative history of section 264. The facts of this case provide ample basis to conclude that these loading dividends would be determined by reference to the contractually stipulated loading charges that were ostensibly being imposed at the same time -- rather than being based on Insurer's experience, or the discretion of management, or any usual source of dividend payment. Neither Taxpayer nor Insurer intended that the gross annual premium specified in each COLI policy actually be paid during each of the first seven contract years. Rather, it was contemplated from the outset that these contractually pre-arranged loading dividends would reduce the premiums actually required to be paid in years in which no borrowing occurred. This contrasts with the normal dividend structure of life insurance contracts generally, both as to the virtual certainty of its payment and as to the dividend being funded directly from a premium allocation to an overstated charge.

We conclude that, for purposes of section 264(c) (1), the "annual premiums due" under each COLI policy equals the Amount H or Amount J annual premium on the specifications page of the policy reduced by the loading dividends. Accordingly, Taxpayer has failed to satisfy the "4 out of 7" exception under section 264(c)(1).

Insurable Interest Issue

For purposes of discussing the issues raised by the Field and the Taxpayer, this memorandum has assumed arguendo the existence of an insurable interest to support the COLI contracts. If Taxpayer did not have an insurable interest in the employees covered by the COLI program when the contracts were issued under the law of State A, the contracts insuring those lives would not be life insurance under applicable law and would fail to qualify as life insurance under section 7702. Since the Field has not questioned whether Taxpayer had an insurable interest in its employees when the COLI contracts were issued, we have not addressed the issue in this memorandum. No conclusions on our part should be inferred from the failure of this memorandum to address the point.

Reauest for Relief Under Section 7805(b)

Taxpayer has requested relief, under section 7805(b), from the retroactive application of the holdings of this memorandum to taxable years ending before its issuance. Section 7805(b) provides that "[t]he Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect."

Section 301.7805-1(b) of the Income Tax Regulations provides:

> Retroactivity. The Commissioner, with the approval of the Secretary, may prescribe the extent, if any, to which any regulation or Treasury decision relating to the internal revenue laws shall be applied without retroactive effect. The Commissioner may prescribe the extent, if any, to which any ruling relating to the internal revenue laws, issued by or pursuant to authorization from him, shall be applied without retroactive effect.

Taxpayer requests section 7805(b) relief asserting that (1) it relied on existing statutory rules, regulations, rulings, and on public statements and reports of Treasury Department officials; and (2) the Service is adopting new standards to deny its interest deductions. Taxpayer also asserts that section 7805(b) relief would be consistent with Congress's decision in 1996 to tailor a phase-out mechanism for existing COLI plans when it passed legislation eliminating the interest deduction for broad-based COLI programs.

There is no regulation, revenue ruling, notice, or revenue procedure of the Service explicitly addressing whether a taxpayer is entitled to interest deductions under the facts presented in this case. Thus, this is not a situation where section 7805(b) relief might be appropriate because a taxpayer relied on an official pronouncement of the Service. Nor was Taxpayer issued a prior private letter ruling or technical advice memorandum covering the issue which might form a basis for section 7805(b) relief. See section 17.01 of Rev. Proc. 98-2, 1998-l I.R.B. 74.

Taxpayer points to the 1988 and 1990 Treasury testimony and a 1990 Treasury report, all of which are cited in the legal analysis above, as support for its position that COLI loan policy interest deductions are allowable. Both the Treasury testimony and the report describe only in general terms the tax consequences of certain insurance products. Nothing in the testimony or the report indicates that Treasury thought the Service was precluded from (1) examining a particular COLI program undertaken by a taxpayer, and (2) determining that the transaction does not give rise to an interest deduction under the Code. Nor is there any indication in the report that Treasury examined all aspects of a particular insurance product and intended to provide guidance to taxpayers on the tax consequences of that product. After carefully reviewing in their entireties the Treasury testimony and report cited by Taxpayer, we do not believe that these documents would form a basis for section 7805(b) relief under the facts presented here.

Nor do we find Taxpayer's arguments with respect to the 1996 COLI legislation compelling. As discussed earlier, in the legislative history for the 1996 legislation, Congress explicitly noted that an interest deduction is permissible "provided the transaction gives rise to debt for Federal income tax purposes." 1996 Conference Report at 319. The legislative history also states that, "In addition to the specific disallowance rules of section 264, generally applicable principles of tax law apply." Id. at 320, fn. 23. And, in amending section 264, Congress noted that "no inference is intended as to the treatment of interest paid or accrued under present law." Id. at 322.

We do not agree with Taxpayer's assertion that we are applying new standards to deny its interest deduction. We are applying existing law to determine (1) whether Taxpayer, in substance, incurred an indebtedness for Federal tax purposes; (2) whether Taxpayer, in substance, paid or accrued interest for Federal tax purposes; (3) whether Taxpayer possessed a non-tax, business purpose for the financing transaction used to acquire the COLI contracts; and (4) whether Taxpayer satisfied the "4 out of 7" test of section 264. We do not believe that the absence of authority applying existing principles of law to Taxpayer's facts is a sufficient basis for granting section 7805(b) relief.

In sum, for the reasons discussed above, Taxpayer's request for section 7805(b) relief is denied.